United States Court of Appeals

for the Second Circuit



APPELLANT'S APPENDIX

76-4277

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

SCHUSTER'S EXPRESS, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

B

P/S

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

APPENDIX

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UNITED STATES COURT OF APPEALS
FILED
APR 4 1977
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

PAGINATION AS IN ORIGINAL COPY

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UNITED STATES TAX COURT
GENERAL DOCKET

DOCKET NO. 7420-73

SCHUSTER'S EXPRESS, INC. (Carl Schuster, Pres.)
48 Norwich Avenue
Colchester, Conn. 06415 PETITIONER.

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

APPEARANCES FOR PETITIONER: Conn. 06511
Newton D. Brenner, 271 Whitney Ave., New Have
NAME (E/A 2/26/75) P. O. Box 1746 06507
ADDRESS

Date Month Day Year	Filings and Proceedings	Action	Served
Oct. 10, 1973	PETITION FILED: FEE PAID Oct. 10, 1973		Oct. 10, 19
Oct. 10, 1973	GRANTED TO NEW HAVEN, CONN. REQUEST by Petr. for trial at New Haven, Conn. filed.	GRANTED Oct. 10, 1973	Oct. 10, 19
Nov. 21, 1973	ANSWER by Resp. filed.		Nov. 26, 19
Nov. 27, 1974	NOTICE OF TRIAL on Mar. 3, 1975 at Bridgeport, Conn.		Nov. 27, 19
Dec. 18, 1974	NOTICE OF CHANGE OF TRIAL DATE from Mar. 3, 1975 to Feb. 24, 1975 at New Haven, Conn. session at Bridgeport, Conn.		Dec. 18, 19
Feb. 24, 1975 Feb. 26, 1975	TRIAL at New Haven (Bridgeport), Conn. before Judge Goffe.		
	Stipulation of facts and joint exhibits attached filed.		
	ENTRY OF APPEARANCE by Newton D. Brenner for Petr. filed.		MAR 11 19
	Petr.'s motion for leave to file an Amended Petition filed - GRANTED		MAR 11 1975
	Amended Petition LODGED - Amended Petition to be filed after verification received from Newton D. Brenner.		
	ORIGINAL BRIEFS DUE: Apr. 28, 1975		
	REPLY BRIEFS DUE: June 12, 1975.		
	SUBMITTED TO JUDGE GOFFE		
Mar. 10, 1975	AMENDED PETITION filed.		MAR 11 19
Mar. 21, 1975	TRANSCRIPT of February 26, 1975 received.		
Mar. 25, 1975	ANSWER TO AMENDED PETITION by Resp. filed.		MAR 26 1975

(Cont. to Page 2)

Form 5...
May 19...

DOCKET NO. 7420-73

(Continuation)

SCHUSTER'S EXPRESS, INC., PETITIONER PAGE 2

Date Month Day Year	Filings and Proceedings	Action	Served
Apr. 28, 1975	REPLY to Answer to Amended Petition filed by Petr.		MAY 6 1975
Apr. 28, 1975	MOTION by Petr. for extension of time to May 5, 1975 within which to file Brief. (No Obj. Resp.) (Statement in support Attached)	GRANTED May 5, 1975	MAY 6 1975
Apr. 28, 1975	MOTION by Petr. to Strike portions of Resp's Answer to Amended Petition.	DENIED May 29, 1975	MAY 30 1975
April 28, 1975	BRIEF for Resp. filed.		MAY 6 1975
May 5, 1975	PETITIONER'S TRIAL BRIEF filed.		MAY 6 1975
May 6, 1975	NOTICE of filing Petr's. Motion on Apr. 28, 1975 with Response due from Resp. on or before May 23, 1975.		MAY 6 1975
May 20, 1975	NOTICE OF OBJECTION by Resp. to Petr's. Motion filed Apr. 28, 1975 to strike, filed.		MAY 21 1975
June 5, 1975	REPLY BRIEF for Resp. filed.		JUN 20 1975
June 20, 1975	REPLY BRIEF for Petr. filed. (PM timely)		JUN 24 1975
June 24, 1976	FINDINGS OF FACT AND OPINION filed, Judge Goffe. Decision will be entered under Rule 155.		JUN 24 1976
Sept. 8, 1976	AGREED COMPUTATION filed.		
Sept. 9, 1976	DECISION ENTERED, Judge Goffe.		SEP 9 1976
	APPELLATE PROCEEDINGS		
Dec. 7, 1976	NOTICE OF APPEAL to U.S.C.A., Second Circuit, filed by Resp.		Dec. 8, 1976
Dec. 8, 1976	NOTICE of Filing with copy of notice of appeal mailed to Mr. Newton D. Brenner, counsel for Petr.		Dec. 8, 1976
Dec. 8, 1976	NOTICE, to parties, of assembling and date for transmission of the record.		Dec. 8, 1976

UNITED STATES TAX COURT

SCHUSTER'S EXPRESS, INC.
Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE
Respondent.

Docket No. 7420-73

HEARING AT Bridgeport, Connecticut

DATE February 26, 1975

PAGES 1 through 78

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UNITED STATES TAX COURT

SCHUSTER'S EXPRESS, INCORPORATED

Petitioner

vs

COMMISSIONER OF INTERNAL REVENUE

Respondent

DOCKET NO. 7420-73

LOCATION OF HEARING: Bridgeport, Connecticut

DATE: March 26, 1975

BEFORE: The Honorable Willaim A. Goffe

APPEARANCES: Newton D. Brenner, for Petitioner

Robert S. Walker, for Respondent

PROCEEDINGS

THE CLERK: Docket number 7420-73, Schuster's Express, Incorporated. Gentlemen, would you state your names for the record?

MR. BRENNER: Newton D. Brenner for the Petitioner. Ready to proceed, Your Honor.

MR. WALKER: Robert S. Walker, for the Respondent, ready to proceed.

THE COURT: Very well, would the parties like to offer the stipulation at this time?

MR. WALKER: Yes, Your Honor. I would like to offer at this time, the Stipulation of Facts, together with exhibits 1-A through 5-E.

THE COURT: Very well, the Stipulation of Facts, together with joint exhibits 1-A through 5-E inclusive will be received in evidence and made a part of the record.

(Whereupon, Joint exhibits 1-A through 5-E, inclusive, were marked for identification and received in evidence.)

THE COURT: Mr. Brenner, would you like to make your opening statement?

MR. BRENNER: Your Honor --

MR. WALKER: I am sorry, there is one further thing that I would like to put before the Court prior to

that time, if the Court please. And I think Mr. Brenner is in agreement with me on this case.

The statutory notice of the deficiency which was attached to the petition omitted one page of the statement attached to that notice. And I would at this time like to submit a joint exhibit, which would be exhibit 6-F, which is a corrected copy of the statutory notice of deficiency issued in this case.

THE COURT: Any objection?

MR. BRENNER: No objection, Your Honor.

THE COURT: Exhibit 6-F will be received in evidence.

**** (Whereupon, Joint exhibit 6-F, was marked for identification and received in evidence.)

MR. WALKER: Thank you, Your Honor.

MR. BRENNER: Your Honor, prior to my opening statement, I would like the Court to take notice that exhibit 1-A, which is Petitioner's tax return for the year 1966, indicates that it was filed with the District Director on September 14, 1967, and that exhibit 2-B, which was Petitioner's tax return for the year 1967, was filed September 16, 1968. I am sorry, excuse me, Your Honor.

The exhibit 1-A, which is the tax return for the year ended June 30, 1967, was filed on September 14,

1967.

THE COURT: Does Respondent agree with that statement?

MR. WALKER: Yes, Your Honor.

MR. BRENNER: And that the statutory notice of deficiency was dated July 10, 1973, and that pursuant to section 6501 A of the Internal Revenue Code, adjustments to taxable income for the year ended June, 1967 would be limited, except in so far as they relate to adjustment arising by reason of then operating loss carry backs to that year.

And I would request that if the Respondent at this time has any waivers which evidence that the tax return for the year ended June, 1967, was open at July 10, 1973, that he come forward with such evidence at this time.

MR. WALKER: Your Honor, the only adjustment made regarding the 19 -- the taxable year ended June 30, 1967, is the disallowance of a net operating loss from the taxable year ended June 30, 1970. Petitioner -- the Respondent has made no other adjustments to the June 30, 1967 return, and the statute of limitations regarding the disallowance of the net operating loss carry back had not expired as of the date the statutory notice was mailed to the Petitioner.

I have no waivers to submit to the Court at this

time. The statutory notice, Mr. Brenner has stated that the statute of limitations would be barred under section 6501 A were it not for the claim regarding a net operating loss carry back. I agree that under section 6501 H, that the statute of limitations does not bar the disallowance of the net operating loss carry back from 19 -- from June 30, 1970 year to the June 30, 1967 year.

THE COURT: Very well.

MR. BRENNER: Your Honor, I would like to file a trial memorandum prior to my opening remarks which might aid the Court, and further, I would like to file a motion for leave to amend the Petition, which shall be discussed as part of my remarks.

THE COURT: Before you make your opening statement, there is a loose document in the stipulation of facts that doesn't have an exhibit number on it, and it appears to be the computation of investment credit for the taxable year ended June 30, 1970.

MR. BRENNER: That is an attachment to the statutory notice of deficiency, Your Honor.

MR. WALKER: No, I think -- Your Honor, I think that should be attached to exhibit 4-E.

THE COURT: Is it a part of 4-D?

MR. WALKER: Yes, Your Honor, 4-D.

THE COURT: That is part of 4-D, all right.

MR. WALKER: Your Honor, with regard to Mr. Brenner's motion for leave to file an amended petition, the Respondent would, of course, like an opportunity to, if necessary, file an answer to the amended petition at some date. I have not yet had any chance to review the amended petition, submitted by the Petitioner. So, I do not know whether this amended petition will have any effect at all on how I wish to proceed in this case.

THE COURT: Does Respondent have any objection to the filing of the amended petition?

MR. WALKER: I cannot answer that, Your Honor, until I have had an opportunity to further review the amended petition.

MR. BRENNER: Your Honor, since the amended petition is in the nature of amendments which conform the petition for the proof of the case, and all of the allegations in the amended petition that are the subject of the amendments, are part of the facts as stipulated, the amendment is one which conforms the pleadings to the proof, and if Your Honor would like to withhold passing on the admission into pleadings of the amended petition until the close of the case, Petitioner would not object.

THE COURT: Very well. We will take it up at the conclusion of the trial, then.

OPENING STATEMENT ON BEHALF OF THE PETITIONER:

MR. BRENNER: The case which we are hearing today, Your Honor, involves the appropriate tax treatment of expenses of Schuster's Express, Inc. which arose during five of its taxable years. It is years ended June, 1966, 1967, 1968, 1969 and 1970.

And the expenses which are the subject of controversy are characterized as insurance expense items, which include Petitioner's disbursements for premiums to insurance carriers, adjusted premiums paid to insurance carriers, with respect to retrospective insurance coverage, items paid by Petitioner for claims to shippers and consignees for lost and damaged freight, and items paid by Petitioner because of substantial loss deductible amounts under collision coverage.

The Petitioner's books and records are maintained so that management can receive operating statements on a monthly basis. And management executives of Petitioner from time to time, have directed that certain expenses be reported in those monthly statements, on an estimated basis. Management feels that where an item may have great amounts of fluctuation, as to disbursements from month to month, it is preferable that it analyze its operation on a basis of an estimate of the expense over the entire year.

For the years in question, 1966 and 1967, through 1970, the monthly reports contain expenses on an

estimated basis for insurance items, for the years '66, '67 and '68, and for that limited part of insurance called loss and damage claims for 1969 and 1970.

In its tax returns for the years involved, the Petitioner deducted the expenses which were accumulated on this monthly estimate, even though not all of the expenses had been discharged by payments to third parties, or otherwise disbursed in the year at issue.

The expense item was accumulated through adjustments to the expense account, and the part of expenses that was not deducted in a particular year, resulted in a credit to a reserve account. The reserve account balance changed from year to year during each of the five years in question, and as appears on exhibit 5-E of the stipulation of facts was $69,980.00 at the end of 1966, and increased in every year, 1967, 1968, 1969 and 1970, when that reserve account balance was $192,940.00, which represents dollars that Petitioner had deducted on various tax returns, in various years, for which cash disbursements had not been made.

An audit was made of Petitioner's records for the years 1968, 1969 and 1970, and the result of that audit was a disallowance of the amount by which the deductions exceeded the cash disbursements in the years 1969 and 1970. The statutory notice says that items

claimed as a deduction are disallowed because you are not entitled to such deduction, and the amounts for 1969 and 1970 are stated as $20,268.00 and $73,533. And those amounts are the amounts of increase in the reserve account for the years 1969 and 1970.

And tax payer has agreed that its method of determining these deductions was erroneous, and has agreed to the deficiency which was the result of the adjustment for those two years. For the year 1968, Respondent has disallowed the amount of $99,138.00. The explanation in the statutory notice is that it is determined that the estimated additions to a reserve for loss and damage claims, based on a percentage of the net sales each month, and claimed as a deduction is disallowed because you have not established that you are entitled to such deduction.

Your Honor, there were no additions to the reserve account for loss and damage claims in the amount of $99,138.00 in the year ended June, 1968, and that is part of the facts which have been stipulated here. $99,138 is a cumulative balance in that reserve account, and that part of the reserve account that was in existence, prior to the year ended June 30, 1968, was $73,020.00, and the only addition to the reserve account which occurred during 1968 was $26,118.00, and as to that $26,118.00 Petitioner has agreed that its method of deduction was

erroneous. It was based on estimates. It was improper, and did not contest the part of the statutory notice which sought to disallow the sum of $26,118.00 in the year 1968. Which leaves the issue in the case, and that is the sum of $73,020.00, which was accumulated in the reserve account prior to June of 1968.

$73,020.00 is evidence that Petitioner deducted $69,980.00 to which he was not entitled appropriately, in the year ended 1966, and he deducted $3,040.00 to which he was -- for which he was not entitled in the year 1967, because those deductions were based on estimates. They exceeded the amount of disbursements acutally made in those years, and the deductions were improper.

At the time of the audit, the year ended June, 1967 and the year ended June, 1966 were closed. The Respondent cannot adjust those years, and the Petition has pleaded that the statute of limitation is a bar to those years. The existence of the $73,020.00 as an opening reserve account balance at the beginning of 1968, cannot be used by the Respondent through a reversal, or through an adjustment which brings that item into income.

This has been -- this issue has been tried by Respondent in other cases, and the Court, the Tax Court, in both instances, of the cases that I cited, has ruled that that is an improper adjustment, that that is reaching

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back into closed years. Now, in the cases I have cited on the foot of page 2 of my memorandum are the Greene Motor Company, and Kenosha Auto Transport. Your Honor, I might note that Kenosha Auto Transport, also involves a company that was in the freight business, and had much the same experience with claim problems that Schuster's Express seems to have.

In many respects, Your Honor, that Kenosha Auto Transport case and the Greene Motor Company case, seem to be all that Petitioner would have to recite to Your Honor, as well as the existence of the statute of limitations, on the basis of the pleadings here before the Court.

However, Petitioner has been advised by counsel, for the Respondent, and was delivered this morning with a trial memorandum of the Respondent, in which Respondent raises the argument, or the theory, that section 481 affords the Petitioner -- or affords the Respondent the ability to bring into income the amount of $73,020.00 which was the total of the expenses that had been deducted in the closed years 1966 and 1967, under the theory of section 481, or by application of section 481.

Petitioner protests the Respondent proceeding with section 481, as a theory, for substantiation of the statutory notice at this time, in that neither Respondent's statutory notice, nor Respondent's answer made reference

to section 481, and this Court has held that it is improper to raise an item which has such special characteristics under the law as grounds for Respondent's determination at the time of the trial, and we have cited to Your Honor, the Riss case which was affirmed under the name of Commissioner Riss's Transport Manufacturing Equipment, in the Eighth Circuit in 1963.

We further protest Respondent's moving forward with a section 481 claim, by reason of rule 39 of the revised rules of the Tax Court. It appears to us that under rule 39, matters which are avoidance or affirmative defense, including res judicata or collateral estoppel must be affirmatively pleaded. And if denials are insufficient to raise such issues. And it would seem appropriate under rule 39 that if the statute of limitations is pleaded, and 481 is to be relied upon as an avoidance of that statute of limitations claim, then an affirmative pleading should have been made.

By the way, I think the record should be clear in Your Honor's mind that the amended petition, which was filed this morning, contains exactly the same language with respect to the statute of limitations being a bar, to amend the initial petition.

We, further, claim, your Honor, that section 481 requires a determination that there has been a change of

accounting methods, and the provisions and subsections under section 481, require a determination of the adjustments which are required in the year of change, and computation of taxable income of Petitioner under two or three different formulas, under section 481, none of which has been done in this case, in the course of the audit or in the course of any of the hearings to date.

That section -- the change of accounting method, which is required under section 481, is an affirmative step which must be taken during the audit procedure, and it is not sufficient that Respondent claim at a time of trial that there was a change in accounting method which came mysteriously out of the heaven.

Further, Your Honor, as part of this case, Petitioner will contend that the adjustments in section 481, are based on changes in the tax payer's method of accounting and that the concept of method of accounting is limited to treatments which have a certain degree of appropriateness and the deductibility of items on an estimated basis is an error. The error exists from year to year, and this is no more a method of accounting than would have been involved if Petitioner had been disbursing checks to its officers, without substantiation for entertainment expenses at the rate of $200.00 a month for five years. And the fact that it is done over the course of

time does not make it a method of accounting.

It would be erroneous in each year as it occurred, and 481 is not available to correct such error.

Petitioner will ask the Court to rule in this proceeding that if the Court allows Respondent to move forward with 481, as part of the case at bar, that the Court determine that the burden of proof, as to the existence of the adjustments under section 481, and the underlying factors there under, the determination or the existence or the method of accounting should be upon Respondent, as these items are an affirmative part of Respondent's claims outside the scope of the pleadings as filed to date.

Thank you, Your Honor.

THE COURT: Thank you, Mr. Brenner. Mr. Walker?

OPENING STATEMENT ON BEHALF OF THE RESPONDENT:

MR. WALKER: Your Honor, since Mr. Brenner explained many of the facts which are covered by the stipulation, and since he narrowed down the issue to the balance in the reserve account of $73,020.00 as of June 30, 1968, as being the only issue, really in dispute, I will limit my comments to that particular issue.

At one point, Mr. Brenner stated that part of the -- the part of the expenses not deducted -- he stated that the part of the expenses which were deducted from the

tax return, and not actually paid, were credited to a reserve account. I think what he meant when he said that was that the expenses which were deducted on the returns, and where payment was not actually made during the year, the balance, the excess went into the reserve account.

What happened in this case was that when the Respondent went in to audit the Petitioner's income tax returns for the years ending June 30, '68, June 30, '69 and June 30, '70, the examining agent determined that during the year ended June 30, '66, the Petitioner had begun using estimates, in order to determine the insurance expense deduction claimed on its return for each year, and what Mr. Brenner has admitted, and it is stipulated to in the stipulation of facts, in each year from that first year ending June 30, '66 through the year ending June 30, 1970, the Petitioner used some sort of estimate to determine his insurance expense.

In every year, the estimates were greater than the actual expenses made. In each year, the excess of the deduction claimed on the return over the actual expenses made, appeared as an increase in the balance, in the reserve account which had been set up by the Petitioner.

At the time of the audit, the examining officer, the revenue agent, determined that the Petitioner was entitled only to deduct the actual expenses in each year.

And was not entitled to deduct an amount based on an estimate, the estimate being based on some percentage of gross receipts.

The Petitioner in the stipulation of facts, has agreed that the amount of the deduction allowable in each of the years ended June 30, '68 through June 30, '70, they have agreed that the amount of the deduction allowable is equal to the actual expenses during those years.

The agent determined that if the Petitioner were going to agree to report his insurance expenses in this manner, then if an adjustment were not made to the balance in the reserve account at the beginning of that first year, as of June 30, 1967, or June 30 -- yes, that is right, June 30, 1967, determined that if an adjustment to the $73,020.00 was not made, the Petitioner would get the benefit of a double deduction in that amount.

And, therefore, the revenue agent determined that the expenses claimed over the five year period had been excessive and in order to bring the allowable deductions to an amount equal to the actual expenses, this $73,000.00 would have to be netted out, adjusted-- there would be an adjustment to the taxable income for the taxable year ended June 30, '68 to avoid the double deduction.

Mr. Brenner stated that the stat notice -- statutory notice of deficiency disallowed $99,000, $99,138.0

of deductions for the taxable year ended June 30, 1968. That is not really the case. What this statutory notice says is "it is determined that the estimated additions to a reserve for loss and damage claims, based upon a percentage of net sales each month, and claimed as a deduction is disallowed because you have not established that you are entitled to such a deduction."

That sentence, in which it states that various deductions are disallowed, does not refer to any particular taxable years. It just states that those deductions are disallowed. The statutory notice goes on to state that, accordingly, your taxable income is increased in the fiscal years ending June 30, 1968, June 30, 1969 and June 30, 1970 by the amounts of $99,138.00 and the remaining amounts for those years, for the other two years.

The statutory notice also says in some of these statements, attached to the notice, that in schedule 3 of the statements attached to the statutory notice, it lists for the taxable year ending June 30, '68, the taxable income disclosed by the return, and then it says unallowable deductions and additional income. It lists insurance claims and depreciation. So that the $99,000.00 is made up of two items, as Mr. Brenner said. An item, approximately $26,000.00, which is the excess between the amounts claimed as a deduction and the actual expenses for the year. The

remainder of that $99,000.00, some $73,020 is made up of an adjustment to prevent the reserve in the reserve account from being deducted twice.

The statutory notice does not state anywhere in it that, that entire $99,000.00 is a disallowed deduction. Mr. Brenner also raised the issue of whether the Respondent had changed to method of accounting, or merely corrected an error. He said in his opening statement that the tax payer has agreed that its method of determining these deductions, talking about the insurance and loss and damage claim deductions was erroneous. He said, the method of determining.

The tax payer was using, and we will show this if necessary, it is stipulated to, that it was determining its insurance expense deduction by using an estimate and a reserve method of accounting. The Petitioner has stipulated that all that is allowable during these years is actual cash disbursements. I don't know what else this could be other than a change of accounting method, if you are changing a corporation from the reserve method of determining deductions to a cash method.

Mr. Brenner also raised the fact that under -- because of alleged deficiencies in the statutory notice, and in the answer, that we cannot use section 481 in arguing that the adjustments are proper. As I just

discussed, the language of the statutory notice, I think it is clear in the decided case law, that there is no statutory requirement as to the form which a statutory notice of deficiency is required to take.

It is our position -- it is my position, and the position of the Respondent, that all that is required by statute, in the statutory notice, is that the tax payer be appraised that the Commissioner of Internal Revenue is asserting a deficiency in a particular amount, and that the tax payer be told what period that deficiency is being asserted for.

There are several cases, which discuss the requirements of the statutory notice, and I cite to you the case of Arthur Sorin, 29 Tax Court, page 959, and I am going a little further here than a regular opening statement. I am really answering to his request that the burden of proof in this case be placed on the Respondent. So, I am arguing as to that point, as well as making a normal opening statement, Your Honor.

In the Sorin case, one of the central issues was whether or not the statutory notice was sufficient. The Court, in that case said, on page 969, that it is one thing for the Respondent to pinpoint the basis of his determination; in that situation, it is not reasonable to permit him without notice to rely on some different and

previously undisclosed ground. He is required under those circumstances to amend his answer specifically -- sufficiently in advance of the trial, if he wishes to raise a new issue.

They go on to say, but when the determination is made in indefinite and general terms, and is not inconsistent with some position necessarily implicit in the determination itself, the situation is quite different. The Petitioner may not without an expressly pleaded admission or stipulation treat the notice as official acquiesence by the Commissioner in all Petitioner's propositions as to this item except those expressly determined adverse to him.

It went on to state that where the statutory notice was general in terms, and sufficiently appraised the Petitioner of the deficiency asserted by the Commissioner and of the periods involved, that the burden of proof would remain on the Petitioner to prove that the adjustments were incorrect.

We also cite to you, the case of Manuel D. Mayerson, M-a-y-e-r-s-o-n, 47 Tax Court, 340, in which the Court reached a similar conclusion. In a 1960 case here in this own Second Circuit, the case of Herman Katz and Gertrude Katz, that is 1960 Prentice-Hall, Tax Court Memo 200, paragraph 60,200. The Tax Court, in that case,

also, determined that no particular form of statutory notice was required by statute, and that as long as the Petitioner is appraised of the amounts involved and the years involved that the notice is sufficient, and that the burden will remain on the Petitioner.

I have copies of these cases, if Your Honor would like to see them.

In his opening statement, the -- Mr. Brenner also referred to a couple of cases, the Greene case and the Kenosha Auto Transport case. I might point out that both of these cases, the years involved in those cases were prior to the Internal Revenue Code -- passage of the Internal Revenue Code of 1954.

The Kenosha case was similar to this case, but the issue there involved not whether 481 would apply, but rather whether the litigation provisions of section 1311, of the Internal Revenue Code were applicable to that particular case. Largely as a result of the Kenosha case, and other cases similar to that one, when the Congress passed the Revenue Act in 1954, which is now the Internal Revenue Code of 1954, they included section 481, specifically for the purpose of making it impossible for a tax payer to receive a double deduction in situations where they did not feel that was necessary.

I think that it is clear, based upon the

stipulation itself, that -- and based upon the arguments that we have had here, that the statutory notice is, in fact, sufficient.

Mr. Brenner is not at all surprised by our argument under section 481, as he has stated to Your Honor earlier in chambers. He has at least for 5 or 6, or even 7 months known that our argument in this case was based upon section 481. This is not a case where the Respondent has come to trial and sprung a brand new issue, totally surprising the tax payer.

We have discussed this case at length, the Petitioner's attorney and myself. There is no surprise whatsoever, and I do not think that based upon the statutory notice, the requirements regarding the issuance of statuory notices, the case law involved, and the facts of the situation regarding lack of surprise, that the burden of proof can be placed upon the Respondent.

I also, do not see, it is my position that the Respondent certainly can proceed in this case, using the argument, using the argument of section 481 that the adjustments made are proper in the 481, and are in fact, required by section 481.

The other thing that I would ask is that the Court, prior to the continuance of the case, I would ask that the Court rule on Petitioner's request that the burden

be placed on the Respondent in this case and I would ask that the Court rule that, in fact, the burden remains on the Petitioner, that the statutory notice of deficiency is sufficient. I think it is important that that decision be made prior to any further proceedings in the case because it will bear on who will go first in the case, and that is important to the government's case.

Thank you, Your Honor.

THE COURT: Thank you, Mr. Walker. Does Petitioner desire to have this burden of proof issue resolved prior to the trial?

MR. BRENNER: Yes, Your Honor. I think that would be -- it would be helpful to Petitioner in terms of the conduct of the trial. If I might, Your Honor, I would like to make some very brief remarks with respect to Mr. Walker's discussion of surprise and the contents of the pleadings. And I want to make it clear to Your Honor, that I am not surprised.

I, also, want Your Honor to be cognizant of perhaps, what some of the history of this case is, and why the rules indicate that things should be affirmatively pleaded, if they can be affirmatively pleaded.

Prior to the issuance of the statutory notice, which is dated July of '73, which is about a year and a half ago, and during the earlier parts of the audit, the

best that Petitioner can determine what Respondent's theory was, in this case -- Respondent's theory was that he could recapture into income, items that were improperly deducted in closed years, if there was a reserve account on the books by restoring the reserve account in income because there was case law that said you could do that.

After Petitioner brought to Respondent's authorities' attention the Kenosha case, which says even though it was pre-'54 Code, it is still good law to the fact that -- to the doctrine that there is no ability to move items which were improperly deducted in early years into current years because there is a reserve account on the books, and Kenosha says that, and it still stands for that.

At the time the statutory notice was issued, and for several months after that period of time, appellate conferees attempted to convince the Petitioner that they could bring back the $73,000 into income because of section 1311, and the mitigation of the statute of limitations provision. And we had meetings, and we had discussions, and we have recitals of cases, and Petitioner forwarded copies of cases indicating that the doctrines under 1311 would not allow Respondent favorable conclusion of the case on that basis, and I would say, in September, or October of 1974, I was advised that -- if I think I

can almost quote it: well, you know what, what we have here is a 481 case, which was interesting, and that was the announcement to Petitioner, that, you know, on the telephone we have a 481 case.

And Your Honor, I am not surprised at this point, and we are prepared to the extent that we can be prepared. There is not reason to ask for a continuance, but it certainly reflects, Your Honor, I think grand deviation from the type of pleading that is intended to be fostered under the rules of this Court.

And I think it is incumbent on the Court to create some discipline, both as to the tax payer's counsel and the government's counsel, if the rules of pleading are going to have any meaning. If the latitude of amendments and presentments of arguments, at the time of trial, is going to be voluminous and extend to items that are discussed in rule 39 of the rules, I think that we are all going to be encouraged to be fairly casual in our pleadings until the date of trial, on the theory that what we may have is an anything goes situation.

I think that the issue of who has the burden of proof, Your Honor, in any event, is totally separate from the issue of whether you allow Respondent to proceed at all, and I think that issue can and should be resolved at this time, and I think that -- the the materials of

481 is material that should properly have been included in the answer, and under rule 142 A, the burden should be determined to be that of the Respondent.

MR. WALKER: May I say one thing further, Your Honor?

As Mr. Brenner pointed out, this $73,000 in the reserve account has been the item which everybody has agreed all along is the biggest item in issue. It is now the only item in issue. The revenue agent determined that an adjustment had to be made to bring that $73,000 into '68, so that it would not be allowed as a double deduction.

Now, I think you get to talking semantics, where you say that it is brought in as an addition to income in '68, or whether you net that out, and decrease the deduction for insurance expense, by an additional amount equaling $73,020. 481 says that the adjustment has to be made.

Now, I think it is true that the agent when he initially made the adjustment regarding this $73,000 was not thinking of section 481. However, this $73,000 has been the main point of controversy all along. The Respondent has been arguing all along that taxable income for the taxable year ending June 30, 1968, had to be adjusted, increased by an amount equaling $73,020 regarding that specific adjustment.

Now, I don't see that it matters whether the

argument Respondent uses at trial is the same or different from an argument which was used during the audit.

The Respondent is not prohibited -- is not limited from using any legal argument it has regarding the substantiation or the verification for a specific adjustment made. I think rule 39 is not applicable in this situation because section 481 is an adjustment section. Although the result of 481 is to be able to reach deductions and to make adjustments which might not otherwise be able to be made because of the statute of limitations, I have never considered that a section 481 adjustment was a matter having anything to do with the statute of limitations.

It is just simply that the statute of limitations, although it still applies, section 481 takes precedence over the normal statutory problems. The statute of limitations does not apply in this case because 481 does not reach back into closed years to make adjustments. What 481 does is to allow the Respondent to make adjustments in an open year, even though those adjustments are the deductions or inclusion of income in this case, even though the deductions had been taken in prior years.

It is not a matter which keeps the statute of limitations open. It is, just simply a section which allows us to make the adjustment in an open year, where specific matters occur. Here, as I said earlier, if the adjustment

is not made, the Petitioner will get the benefit of a double deduction, of $73,020.

It is not a question of whether he is going to get the deduction or not get the deduction. It is a question of whether he is going to get it once or twice. And we believe that 481 was passed for that very reason, to make sure that tax payers were not able to get the benefit of using erroneous methods of accounting, and letting the statute run, and then having the matter changed by the Commissioner, and still being able to get the double deduction because the Commissioner changed to a proper method.

Thank you, Your Honor.

THE COURT: Anything further, Mr. Brenner?

MR. BRENNER: Thank you, Your Honor. I want to be as brief as I can. Mr. Walker indicates that section 481 is not an avoidance or is not a statute that he regards as connected with the statute of limitations, and which is contradicted by his own discussion of 481 stemming out of the Kenosha Motor Transport case, and cases like that, which found statute of limitations standing in the way of the ability to amalgamate and shift income items and deduction items through years where there were changes in accounting methods.

It is clearly related to the statute of

limitations. And the concept of, you know, I don't know if it is emotional or non-emotional, but a discussion of what we are talking about here, is whether we are going to be faced with double deductions or single deductions.

The statute of limitations is a very important part of the Internal Revenue Code, and it has been in the Code for as long as all of us who are practicing here have been in practice, and I don't think that we, as practitioners can attach any emotional content to whether, if in the application of this case, the tax payer would have, in fact, deducted an item, doubly, or that he would have attained a deduction for which he had never, in fact, expended the cash because the next case that is going to come along, some tax payer is going to be faced with a duplication of his income by reason of failure of audit or an omission on his part, where the tax payer did not go in and file a claim for refund within the statutory period.

And I am sure that Your Honor is aware of that aspect of the law. Thank you.

THE COURT: Well, I am sorry I don't look upon the issue the way either one of you look upon it. The statutory notice disallows a deduction for claims because Petitioner has not established that it was entitled to them. Now, to my knowledge, a Petitioner is never entitled

to deduct a reserve account anyway. That isn't even the way a reserve for bad debt account works. You don't deduct the reserve. You deduct additions to the reserve, in the current taxable year because the total balance of the reserve clearly reflects what the exposure of the tax payer is going to be for that liability.

In the first place, I don't know whether this tax payer filed its returns on the cash or accrual method of accounting. I assume that it was on the accrual method, but that hasn't even been stipulated. But the Respondent has disallowed the deduction because the Petitioner has not established that it is entitled to the deduction.

Now, to claim an amount of some $73,000 as a deduction because it is a reserve account, doesn't establish anything. It is merely a book entry, and it is apparently a resulting book entry of transactions that went on prior to the taxable year involved.

Now, if the tax payer is on the cash method of accounting, it can only deduct expenses that are paid within the taxable year. If it is on the accrual method of accounting, it can deduct an addition to expenses paid, liabilities which are fixed and determined at the end of that taxable year. I think that is the issue in this case. And I think the statutory notice, which is based on the broad language of a disallowance because the tax payer

hasn't established that it is entitled to the deduction, encompasses almost any theory.

I think that puts the tax payer on notice that it must establish entitlement to the deduction for some reason or another. It has either paid the money, or it has incurred a fixed and determined liability, which gives rise to the accrual of the item, but I know of no section of the revenue code which permits a tax payer to deduct a reserve account.

So, I think the statutory notice is sufficiently broad to put the Petitioner on notice that it must establish the reason for the deduction. And I don't think it is immaterial to me, whether double deductions are involved or not. I don't think that is the question. If the tax payer was using estimates to arrive at this deduction, and the Respondent has disallowed it, then it is incumbent upon the tax payer to show that its method of accounting or estimating or whatever you want to call it, clearly entitles it to that deduction.

MR. BRENNER: Excuse me, Your Honor, may I make reference to exhibit 5-E, which may be a point of clarification for Your Honor.

THE COURT: Yes.

MR. BRENNER: Under the column headed June 1968--

THE COURT: Right.

MR. BRENNER: There is a column headed insurance expense, and under June 1968, the total of 5 items is $413,198.00.

THE COURT: Right.

MR. BRENNER: Which the stipulation of facts says is the amount that Petitioner deducted in its tax return as insurance expense. Two columns over, is a column entitled cash disbursements, and 3 items there total $387,080.00. And it has been stipulated that that amount was disbursed in cash for insurance expense for the year 1968.

Petitioner did not claim $413,198 as a deduction because it had a $99,138 reserve. Petitioner claimed as deductions for the year 1968, and the stipulation of facts, contains affirmation that the total disbursements for the year 1968 were $387.080. And there can be no disallowance from the deducted item of $413,198, greater than $26,118, which does not have the effect of penetrating the actual cash disbursements by Petitioner.

Can I review that again, with Your Honor?

THE COURT: No, I follow you.

MR. WALKER: If I may add, we are in agreement on that point.

MR. BRENNER: Thank you.

MR. WALKER: And Mr. Brenner, as part of the

stipulation, we have stipulated that the difference between the insurance expense claimed on the return and the cash disbursements, which is $26,118, we are not arguing over the disallowance of that portion.

Mr. Brenner,-- the Petitioner has stipulated that that amount is a disallowance which he has no dispute with. In the stipulation, we have agreed that in each year, the difference between actual expenses, and claimed expenses, the difference between cash disbursements for expenses and the expenses claimed on the return, is properly disallowed. The only item of dispute is the year ended June 30, '68, we made an adjustment to income of $99,138.

Your Honor mentioned that we disallowed $99,138. That, although it is a matter of semantics, is not totally correct, I do not think.

THE COURT: Well, you have adjusted income for that amount.

MR. WALKER: We adjusted income. We disallowed $26,118. We made an additional adjustment of $73,020, which was the amount -- balance in the reserve account at the beginning of the year.

THE COURT: But it was never claimed as a deduction.

MR. WALKER : It was claimed as a deduction on the prior years' returns.

THE COURT: Well, then, you are adjusting for prior years. That has never been stated. Are you disallowing the $73,020 because it was claimed in prior years.

MR. WALKER: No. No, Your Honor, section 481, if I may refer to that says --

THE COURT: Would the Clerk get me a copy of the Internal Revenue Code.

THE CLERK: Yes, Your Honor.

MR. BRENNER: Would Your Honor like to go off the record for a moment?

THE COURT: No.

MR. WALKER: Section 481, Your Honor.

THE COURT: Well, I know what 481 is about, but the statutory notice says that the Petitioners have claimed this amount as a deduction, and then you say, it is disallowed. That isn't correct.

MR. WALKER: In my opening statement, I discussed this, Your Honor. I mentioned that on page 2 of the statement, of the corrected notice which we submitted earlier. I don't know if you have the copy of it.

THE COURT: I have it right in front of me.

MR. WALKER: The statement -- it says statement at the top of the page, following the actual letter. The first paragraph, it says: it is determined that the estimated additions to a reserve for loss and damage claims,

based on a percentage of net sales each month, and claimed as a deduction, is disallowed because you have not established that you are entitled to such a deduction. That sentence does not refer to any particular year.

It goes on to say, accordingly, your taxable income is increased, and then it lists the years. What I am saying, Your Honor, is that when we made the adjustments for the taxable year ended June 30, '68, we actually disallowed the claimed expense of $26,118. Then, in accordance with the requirements of section 481, we made an additional adjustment to the Petitioners return for the taxable year ended June 30, '68; the result of that adjustment is to decrease the Petitioner's claimed deduction for insurance expense by an additional $73,020, which was the balance in the reserve account at the beginning of the year.

And as 481 A(2) says, there shall be taken into account, those adjustments which are determined to be necessary solely by reason of the change, in order to prevent amounts from being duplicated.

Now, when the Respondent changed the Petitioner's method of accounting, from the reserve estimated method, to the cash method, and the Petitioner has agreed that with regard to insurance expenses, they are only entitled to deduct cash actually expended. That is stipulated. When

we make that change, in accordance with section 481, we are required to make an adjustment to taxable income in the year of change, which the year of change is June 30, '68 to account for the balance in that reserve account, $73,020, because if we do not make that adjustment, and solely because of the change of accounting method made by the Respondent, the Petitioner would receive a double deduction for that amount.

And that is what the case, as I see it, is all about.

THE COURT: Well, I don't think your statutory notice covers the adjustments then, because the statutory notice doesn't even say what years, you are talking about with the additions to the reserve for the loss. It presumes that you are talking about the years that have been examined. You don't mention any previous taxable years, where there has been an erroneous deduction.

MR. WALKER: That is correct, Your Honor.

THE COURT: So, I will agree with Petitioner that the statutory notice does not put the tax payer on notice that deductions for prior years are being disallowed in the current years because they are double deductions under 481.

MR. WALKER: We are not disallowing any deductions for any prior years.

THE COURT: You are disallowing a deduction because it has been claimed in a prior year, and you claim it is a double deduction because of the method -- the change of accounting method.

MR. WALKER: Well, as I said earlier, Your Honor. It gets to be a matter of semantics as to whether we are disallowing the deduction in the '68 year, in the year of change, or whether we are taking the amounts previously deducted and adding them back into the taxable income for the '68 year.

The reason that I do not believe that the -- well that I do believe that the statutory notice is sufficient is because, the tax payer has been appraised in the statutory notice that the Commissioner of Internal Revenue is asserting a deficiency for the taxable year 1968. The amount of that deficiency is stated, and the reason for that adjustment -- the reason for the deficiency is, although maybe not as well as could possibly have been done, but the reason for the adjustment is stated well enough in there, to put the tax payer on notice as to why the adjustment is being made.

I might, also, add that the tax payer was well aware that this entire case , starting well prior to the issuance of any notice, that this adjustment was being made because of the argument over this $73,000, as well as the

other adjustments.

THE COURT: Well, whether he had -- counsel had actual notice or not, is immaterial, within the framework of the pleadings, is the way this has to be decided, and the way the pleadings stand, I find that the statutory notice merely disallows a deduction for failure to substantiate, and that does not encompass 481, where you are going to refer to prior years to see what was deducted on the return.

So, my decision is that if Respondent wants to rely on section 481, that Respondent has the burden of proving that it comes within 481. And that will be my ruling on Petitioner's request that the burden of proof is on the Respondent.

MR. WALKER: For the record, Your Honor, I would like to take exception to the ruling.

THE COURT: Well, you don't need to take exception to Tax Court, you know that. You take exception when you have been ruled against, and you can argue it on brief. The Court will recess until 2:30, at which time, it will take up the rest of this case.

THE CLERK: All rise. This honorable Court stand recessed until 2:30.

(Whereupon, the hearing recessed as described at 1:00 p.m.)

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AFTERNOON SESSION (2:30 p.m.)

THE CLERK: All rise. By order, this honorable Court is now in session. Please be seated and come to order.

THE COURT: Does that take care of all the preliminary matters? Okay.

MR. BRENNER: Your Honor, as part of my opening remarks, I addressed myself to the issue of the ability of the Respondent to go forward with the argument or presentation or facts under section 481 because that issue was not pleaded to, and Your Honor has ruled on the burden of proof, and indicated that Respondent has the burden of proof. And I am, formally, moving that the Court, pursuant to rule 41 B, not allow Respondent to amend its pleadings to conform to the evidence, as respects section 481, in that, it is Petitioner's view that justice does not so require.

And it is Petitioner's view that it is in the best interest of the practice of this Court that such amendment not be allowed.

THE COURT: May I have a copy of the rules, please? There is one on the desk right up there. Now, you are relying on what rule? You might give him his own copy back, and I will keep this copy.

MR. BRENNER: Well, if Your Honor, please, the

-- on the basis of our discussion of this morning, the section 481, as an issue, in this case, is not a part of the statutory notice, or a part of Respondent's answer. And if that matter is to be presented at the trial, it would be normal in the course of the proceeding, to -- at the close of the trial, amend the pleadings to conform to the proof.

And rule 41B, which speaks to amendments to conform to the evidence, indicates that if evidence is objected to at the trial, on the grounds that it is not within the issues raised, the Court may receive the evidence and at any time, allow the pleadings to be amended to conform to the proof, and shall do so freely, when justice so requires, and objecting party fails to satisfy the Court that the admission of such evidence would prejudice him in maintaining his position on the merits.

And my statement, at this time, Your Honor, is that we do object to the introduction of evidence under 481 B to establish the parameters for Your Honor's ruling on that motion, if at the close of the trial, Respondent moves to conform the pleadings to the proof.

THE COURT: Would you like to speak to that, Mr. Walker?

MR. WALKER: Your Honor, I am not sure I was able to follow that argument. It appears that what Mr.

Brenner is arguing is that because of your ruling this morning, that the Respondent had the burden of proof in the case, and since he is alleging that 481, the argument of 481 is a new issue raised by the Respondent, the Respondent will be required, at the close of the trial, to amend its pleadings to conform to that proof.

I would certainly argue that if it is necessary for the Respondent to amend its pleadings to conform to the proof, then the Respondent should be allowed to do so at the conclusion of the trial, and it should not be barred from doing that.

I do not think, however, that it is necessary for the Respondent to amend its pleadings. The rule 41 B, referred to by Mr. Brenner, states that while the Court -- the failure to amend does not effect the results of the trial on issues, in which an amendment might be necessary.

It appears to me, that in this particular situation, no amendment would be necessary at the conclusion of the trial for purposes of protecting the interests of the Respondent. I would probably move to have the pleadings amended at the conclusion of the trial, to cover any possibilities that might arise.

That is the only response I would have to the motion.

THE COURT: Well, I don't think this rule 41 B

covers the situtation in this case. Respondent, I have held, has the burden of proving that Petitioner comes within the ambit of 481, but that is merely a theory. It is not a new issue in the case.

The issue is framed by the statutory notice, because it disallows the amount of the deduction. Now, my holding as to the application of the 481, merely goes to the theory, under which that deduction -- under which that amount is restored to income. It doesn't set up a new issue in the case. 41 B, I take it, refers to new issues, where there is an item, either disallowed during the course of the trial, where Respondent contends that items should be disallowed, or additional income is charged to the party during the course of the trial by the Respondent.

And in that case, it would be necessary to amend the pleadings to conform with the proof, if Respondent wanted to raise that as an affirmative issue. But here, the Respondent hasn't raised an affirmative issue. The Court has merely held that that issue, as framed by the statutory notice, does not embody the theory of section 481. So, an amendment to the pleadings is not necessary in this case.

MR. BRENNER: Thank you, Your Honor. It is Petitioner's reading of the section that if the Respondent was permitted to go forward, without objection by Petitioner

then Petitioner would lose its right to object, upon the conclusion of the case to any amendment to conform the pleadings to the evidence that Respondent might wish to make.

And I am rising at this time, Your Honor, only to indicate my objection, for purposes of the rule, and it was my thought that it was not necessary for Your Honor to rule on the matter at this time. It is my reading of the rule that it requires an objection, otherwise, Petitioner has lost its right, and I wanted to make that objection for the record.

THE COURT: Very well.

MR. BRENNER: Thank you, Your Honor.

MR. WALKER: Your Honor, there is one further point, which I would like to just inquire. I have been talking with Mr. Brenner since -- during the recess. Your ruling this morning, which stated that the Respondent had the burden of proof, with regard to the 481 theory, in discussing this with Mr. Brenner, it seems that his thoughts are that if the case proceeds on that basis, and the trial is concluded, obviously in my brief, I will be making arguments to try to convince Your Honor that the burden should remain with the Petitioner.

And if that were successful, or if I were successful in that argument, then we would be placed in

a situation where prior to trial, the Petitioner thought the burden was on the Respondent. The trial goes on, and after the trial, the Petitioner learns that the burden was on him, after all. And I would think that that could cause -- may well be a reason for some type of neutrality in the case.

I am not real certain about the procedure in this type of matter, and I can find nothing in the rules, which would permit the issue of burden to be severed from the case, and finally decided by the Court, prior to presentation of the case. If there -- if that is a possibility, I think that might be wise. Otherwise, we could possibly be placed with the problem of having to put on a trial in this case two times.

THE COURT: Well, let me ask you this, are you relying solely on 481?

MR. WALKER: Yes, Your Honor.

THE COURT: Well, I look at it this way, I have ruled on the burden of proof, and I think the burden of going forward will follow the burden of proof. I don't see how Respondent can be prejudiced unless Respondent loses the case. You are not going to appeal if you win it, on the basis of 481. If you lose it on the basis of 481, and argue that Petitioner should have had the burden of proof, well, then, you can get me reversed on that

grounds, I take, if I have interpreted the law wrong.

MR. WALKER: All right, Your Honor, I was just trying --

THE COURT: And the Court of Appeals would remand it back to the Tax Court for a trial, requiring the Petitioner to bear the burden of proof.

MR. WALKER: I was just trying to avoid the possibility of having a -- possibly two trials in the case, Your Honor.

THE COURT: Well, if I severed the issue and wrote an opinion on the severed issue, that wouldn't even be a final decision of the Court and the losing party couldn't even appeal it. That would be an interlocutory order, which isn't subject to appeal.

MR. WALKER: That was what I wondered. I knew I was not able to find any procedure where that could be brought to final determination, and I was --

THE COURT: Well, you see, it couldn't be because for a case to be final, for purposes of appeal, a decision has to be entered in the case, and we couldn't possibly enter a decision in the case without deciding the case on the merits. That is the trouble with a severed issue. Many times the Court will grant a motion to severe, if it will dispose of the case completely, one way or the other. But you see here, the question of burden of proof

won't dispose of the case completely, either way I go. Someone still has to go forward with the proof, so I don't think anything would be gained by severing the issue.

MR. WALKER: Thank you, Your Honor. I am ready to proceed.

THE COURT: Very well. Would you like to call your first witness?

MR. BRENNER: Your Honor, as a matter of form, while Respondent has the burden of proof on the issue of 481, I think it is incumbent on Petitioner to initiate the case.

THE COURT: Go ahead.

MR. WALKER: No objection.

THE COURT: I doubt if Respondent will object to that.

MR. BRENNER: And simply, Your Honor, Petitioner will submit its case, in chief, on the basis of the stipulations of fact, and the exhibits, and the stipulations as to the statute of limitations. And the Petitioner's case, in chief, will rest.

THE COURT: Very well.

Would Respondent like to call his first witness?

MR. WALKER: Yes, Manuel Faria, please.

THE CLERK: Raise your right hand, please. Do you solemnly swear that the testimony you are about to give

will be the truth, the whole truth and nothing but the truth, so help you God?

THE WITNESS: Yes, I do.

THE CLERK: Please be seated and state your name and address for the record.

THE WITNESS: I am Manuel V. Faria, of 19 Billard Road, New London, Connecticut.

THE CLERK: Would you spell that, Sir?

THE WITNESS: F, like in Frank, -a-r-i-a.

M A N U E L V. F A R I A,

having been called as a witness by and on behalf of the Respondent, and having been duly sworn, took the stand, was examined and testified as follows:

*** DIRECT EXAMINATION

BY MR. WALKER:

Q Mr. Faria, where are you presently employed?

A With the Internal Revenue Service.

Q What is your position?

A Internal Revenue Agent.

Q How long have you been employed as an Internal Revenue Agent?

A 29 years.

Q When did you -- during what period of time does this 29 years cover?

A From February, 1946 to the present date.

Q What are your duties as an Internal Revenue agent?

A To examine books and records and tax returns of tax payers, whose returns are assigned to me.

Q During the course of your employment as an Internal Revenue agent, can you give me an estimate of how many tax returns you have audited, during the period?

A It would be very difficult. An off-hand number--

Q Just an estimate. How many returns a year might you audit?

A 20.

Q 20, okay. At the present time --

A Depending on the size, it could be more.

Q What is your present -- to what division are you presently --

A I am with the audit division.

Q The audit division. During the course of your employment as an Internal Revenue Agent, did there come a time when you were assigned a case of Schuster's Express, Inc.?

A Yes.

Q Can you explain why you were assigned to those-- to audit that particular corporation?

A Well, I assigned that return, due to an operating loss carry back. The tax payers had filed a claim 1139,

requesting a refund, a quick refund for a carry back loss from 1970 to '67. And this was the reason for the audit. After the refund is made, as a revenue agent, we go into examine if the refund claim is proper.

Q During the course of your work on that case, did you have occasion to examine the books and records?

A Yes, I did.

Q Of Schuster's Express?

A Yes.

Q What years did the examination cover?

A The examination covered the years '68, '9 and '70. Due to the carry back loss, it involved going back to '67, and also because of this, it triggered an investment credit carry back to '64.

Q When you say the years '67 and '69, you are talking about the taxable years ended June 30 in those years?

A June 30th, fiscal year June 30th, all years.

Q During the course of your audit of these tax returns, did you have -- did you examine the deductions claimed on those returns for the years ending June 30, '68, '69 and '70, for insurance expenses?

A Yes, I did.

Q As a result of the examination of these insurance expense claims, what did you fi[illegible]? Were you -- let's put

it this way, as a result of looking at the insurance expenses claimed for the years '68 through '70, were you required to look at earlier years returns, and earlier years book and records, to determine --

A Yes.

Q Various items?

A Yes. This involved going into '66 and '67.

Q Can you explain what you found when you looked at the books and records regarding the insurance expenses?

A I found that a reserve for insurance was on the books and records, and this involved estimated expenses for insurance on cargo, for loss on cargo and damage claims.

Q Did the -- regarding the years '68, '69 and '70, June 30, '68, '69 and '70, what did you find, regarding the actual deduction claimed for insurance expenses, and actual cash expenditures for the year, regarding insurance expenses?

How did they relate to one another?

A The actual cash expenditures, in relation to the actual expense on the return, you mean?

Q Yes, Sir.

A The difference, I found was an estimated figure, percentage of revenues.

Q And where did this estimated figure show up

on the tax payer's books and records?

A It was claimed as a deduction under insurance expense, account 4500 or 4550. I am not certain at this point, and the reserve account was 2180 B.

Q And the excess --

A Later changed to 2680.

Q The excess showed up in this reserve account?

A Yes.

Q For the years ended June 30, '69 and June 30, 1970, what was the adjustment made to those years, regarding insurance expense?

A The difference between actual expenditures and the amount claimed on the return.

Q For the year 1968, did you make a similar type of adjustment?

A Yes.

Q Can you explain what that adjustment was made on?

A That was the difference between actual and that claimed on the return, plus an estimated figure, which represented an opening balance on 7/1/67 of $73,020. That is correct, $73,020.

Q What was the method of accounting, if you can explain it as briefly as possible? The method of accounting used by Schuster's Express during the taxable years,

June 30, 1966 through June 30, 1970, to determine the amount of the insurance expense deduction claimed on their returns?

MR. BRENNER: Excuse me, Your Honor, I am going to object to inquiries directed under the phraseology, method of accounting. I think that the method of accounting is an ultimate fact, which must be found by this Court, whether there existed or did not exist a method of accounting, because method of accounting is statutory language in section 481.

And I think it would be helpful if the inquiries were addressed in words, which are not statutory words, which are going to be the ultimate basis of the elements, on which this case is going to be decided.

THE COURT: I think it is relevant to inquire as to the method of accounting used by the tax payer generally, with respect to keeping the books and records, but I don't think it is appropriate to describe a particular item by method of accounting. I think I will sustain the objection, but permit Respondent to inquire as to how the item was treated on the books and records.

MR. BRENNER: Thank you, Your Honor.

BY MR. WALKER : (RESUMING)

Q Okay, to rephrase the question, and try to approach it from a different light, what was the method of accounting generally used by the tax payer?

A The accural method of accounting.

Q Did the method used by the tax payer, to determine the expenses for insurance claims differ from the method used by the tax payer to determine other expense items?

A They were using the cash method.

Q I am not sure I understand the answer. Let me rephrase this.

A Yes.

Q You say the tax payer was using generally, the accural method of accounting?

A Yes.

Q For purposes of determining the deduction claimed for insurance expense, I think it has been stipulated that they used estimates?

A Yes.

Q Did they use estimates for other types of expenses, expenses other than insurance expense?

A No, they did not, just the insurance.

Q Okay. When you audited those returns, what was your determination as to the allowable deduction for insurance expense?

What did you look to?

A I looked only for the actual expenditures, not estimates.

Q You looked at actual cash expenditures?

A Yes.

Q So that, your recommendation was that the tax payer be allowed deductions only for actual cash expenditures for insurance expenses?

A Yes.

MR. BRENNER: Objection, Your Honor, leading the witness.

THE COURT: Overruled.

(Pause.)

MR. WALKER: I have no further questions.

THE COURT: Would you like to cross examine?

MR. BRENNER: Thank you, Your Honor.

****

CROSS EXAMINATION

BY MR. BRENNER:

Q Mr. Faria, I would like to hand you a copy of a schedule, which has the contents described as exhibit 5-E. Have you had an opportunity to review that schedule, prior to this time, or would you like to spend some time reviewing it?

A No, I sort of reviewed it here today, this morning.

Q Mr. Faria, in connection with your examination of Schuster's records and examination of the insurance expense for the years 1969 and 1970, you determined a

disallowance for 1969 in the amount of $20,268 and for 1970 in the amount of $73,534.

A Yes.

Q Is that correct?

A Yes.

Q And your determination, with respect to the year 1968, was a disallowance of $99,138?

A Yes.

Q Was $99,138 the amount by which the cash disbursements of Schuster's for insurance that year, differed with the amount it claimed as a deduction?

A The difference between the cash and the amount claimed was the $26,000.

Q The difference between the cash and the amount claimed was $26,000?

A 118, right.

Q And your disallowance was $99,138?

A Yes.

Q And by arithmetic, that difference is $73,020?

A Yes.

Q And can you tell the Court the basis for this disallowance, that led you to determine to disallow that amount?

MR. WALKER: Your Honor, I would object to that as being irrelevant in that what the revenue agent felt

was the reason for the disallowance and what the final determination by the Commissioner as the reason for the disallowance, are not necessarily connected.

THE COURT: Normally, that is true, but I think you have waived it by asking this agent to explain his adjustments when he went into the books and records, so I will overrule your objection.

MR. BRENNER: Can you answer -- is there a way for her to repeat the question, or would you like me to reask it?

THE COURT: Yes, she can play it back.

MR. BRENNER: Would you do that, please?

(Whereupon, the requested portion was played back by the reporter.)

BY MR. BRENNER: (RESUMING)

Q Mr. Faria?

A Yes.

Q You are being asked to answer the question, which was repeated on the tape?

A If I was to allow the $73,020, the opening balance to go by without being adjusted it would mean, the tax payer would have had a double deduction. And my job is to protect the interests or the revenue for the government, and this, I thought, to be improper. And in the change of method of accounting, made by the government,

the opening balance is not allowed to escape taxation.

Q Mr. Faria, you remarked in your answer that in a change of accounting by the government, the opening balance is not allowed to escape taxation. Is it your testimony that there was a change in accounting by the government that allowed you to include opening items for taxation, under any special provision of the Internal Revenue Code, or is that a generally understood area of the law?

MR. WALKER: Your Honor, I wonder -- I would like to object to the question as being-- he really asked two or three questions, and it is going to be rather difficult for the witness to try to answer that question. If he could split that question up so that the witness can give some specific answer to the question, rather than trying to --

THE COURT: I will sustain the objection.

BY MR. BRENNER: (RESUMING)

Q Mr. Faria, is it your testimony that at the time of Schuster's audit, you changed a method of accounting of Schusters?

A I changed the reserve method for an estimated reserve method for insurance expense, from an estimated item to an actual.

Q Mr. Faria, referring again to exhibit 5-E, can you tell from that exhibit, the amount, which was

deducted for insurance expense, and the amount which was deducted -- and the amount which was disbursed in cash by Schuster's in the year 1966?

A Is this it?

Q Yes.

A The insurance expense was $387,471, and the cash disbursements was $317,491.

Q Was there an erroneous deduction by Schuster's in that year?

A Yes.

Q In the year ended 1967, can you tell the Court, the amount which was claimed as insurance expense, and the amount that was disbursed in cash?

A The insurance expense claim was $371,763, and the cash disbursements was $368,723.

Q Was there an erroneous deduction by Schuster's for that year?

A Yes.

Q And what was the amount of that erroneous deduction?

A $3,040.

Q The years in which those two deductions were erroneous were the years 1966 and 1967?

A Fiscal years, yes.

Q If the years 1966 and 1967 were open at the time

of your audit, would you have determined a disallowance of those items?

A Yes, because you had changed your method of handling an item without permission, securing permission from the revenue service. This would be one of my reasons for making the change. Besides being an estimated figure of revenues, percentage of revenues. You did not secure permission to make this change.

Q And which change is this, Mr. Faria?

A In '66 and '7, '68 and '69, you initially made the change in '65.

Q So the change that you are speaking of, Mr. Faria, the change from 1965 to 1966, when tax payer first used estimates as a basis for his -- some of the deductions?

A As far as -- yes.

Q You are not speaking of a change in '68, '69 or '70, as far as the tax payer changing the basis of treating these items?

A No , what you did was change to percentages..

Q Mr. Faria, is there any special procedure which you are aware of, which must be followed when there is a determination by the tax Commissioner to change an accounting method?

A Any procedure on my part?

Q Any procedure on your part, as an agent for the

Commissioner, or any other procedure that you are aware of?

A No.

Q No.

A You are bringing out, discussing the year of change --

Q There is no question pending, Mr. Faria.

A All right.

Q Mr. Faria, I would like you to identify the book which I have just handed you.

A It is a tax, CCH tax guide, Internal Revenue manual, volume II.

Q Is that a commercial reproduction of the offical Internal Revenue Manual, as best you can identify it?

A Of the Code or the Manual?

Q Of the Manual?

A The Internal Revenue Agents' Manual?

Q That is right.

A I don't know if it is.

Q As best you can identify it?

A I don't know if it is. Let me look.

MR. BRENNER: May I hand Your Honor a copy of the book?

THE WITNESS: Yes, all right.

BY MR. BRENNER: (RESUMING)

Q Your testimony is to the best you are able to

determine, this is a --

A Reproduction of our manual.

Q Reproduction of the Revenue --

A Yes, this is guidelines, yes.

Q Now, Mr. Faria, commencing on page 7225-18 of the manual, there is material under the heading, Guidelines for Considering Changes in method of accounting.

A Yes.

Q Did you examine and consider that material at the time of Schuster's audit?

MR. WALKER: Your Honor, I think I will object to this whole line of questioning because I don't see the relevancy between the -- this particular manual provisions, and the question of whether or not, the Commissioner has changed the method of accounting.

It seems to me that whether or not, a method has been changed is a question which has nothing at all to do with, first of all, what these manual provisions may require, and secondly, it doesn't matter whether the manual provisions were followed.

MR. BRENNER: Well, Your Honor, I think the manual is a standard of normal practice, and as a standard of -- which gives us clues to what may have really happened in the course of this audit, which I think are relevant to pursue.

THE COURT: You haven't alleged that the examination was arbitrary or capricious. How is it relevant to determine whether he made an arbitrary determination or a non-arbitrary determination?

I don't think it is relevant either.

MR. BRENNER: Your Honor, it is my allegation tha he has made no determination of the change of accounting method.

THE COURT: He testified that he d.

MR. BRENNER: And he is, the Res, ent's witness, and he is being cross examined.

THE COURT: I don't think what the manual provides has any bearing on that question, though. I will sustain Respondent's objection.

MR. BRENNER: Well, Your Honor, do you sustain objection to all questions based on the manual?

THE COURT: Yes. The Internal Revenue Manual isn't relevant to this issue.

MR. BRENNER: Well, if I may belabor the point for one more moment, Your Honor. The Internal Revenue Manual, at item 424, 11.6 under the topic, year of change and issues debated by the service, in computations, indicates a series of computations, and in the form of those computations, which an agent is to follow if he is proceeding under that section. And I think it is

relevant, in a determination as to whether he did or didn't effect a change of accounting method, or effect a change in the treatment of an item, as to whether he did, pursue those changes.

THE COURT: I don't agree. The question in the case is what he did, and not what the manual required him to do. What the manual required him to do has no bearing on the issue. The question is what did he do, why did he do it?

He has testified that the tax payer had a practice prior to 1965, apparently, or deducting the actual insurance expenses incurred. And subsequent to the year 1965, he used a reserve method, based on estimates, and he claims that that method did not -- was not proper, and therefore, he disallowed it, and whether the manual permitted him to do that or not, is immaterial to what he did because you haven't alleged that what he did was arbitrary and capricious.

You can't go behind the revenue agent's actions, unless you have alleged that the actions are arbitrary and capricious, and that the statutory notice, on its face, is arbitrary, and therefore, the burden is shifted back to the Respondent. What the agent is required to do, isn't material.

(Pause.)

BY MR. BRENNER: (RESUMING)

Q Mr. Faria, can you explain to this Court, how Petitioner would have availed itself of a double deduction with respect to the $73,020, if you did not disallow that item? Or disallow that amount in addition to the $26,118 in your 1968 adjustments?

MR. WALKER: Your Honor, one objection with regard to that question. Just as he is referring to, once again, a disallowance, and I hate to argue semantics, but the adjustment made, although it may be termed a disallowance, 481 talks in terms of adjustment to taxable income rather than disallowances or additions, and I think it is best to refer to the adjustment made with regard to this $73,000 item as an adjustment, rather than either an allowance -- a disallowance or --

THE COURT: I agree because he didn't disallow a deduction with respect to the $73,020.

BY MR. BRENNER: (RESUMING)

Q The question, Mr. Faria, is can you tell the Court on what basis there would have been a doubling up of items if they were not otherwise adjusted?

A I would have to see the RAR again, and --

Q Your Revenue Agent's Report?

A Yes, Sir.

Q Let the record show that the witness is

examining a Revenue Agent's Report, delivered to Petitioner under date of March 7, 1972.

(Pause.)

A Well, treating this reserve as an accrual it would normally have been the practice to reverse out the $73,000 at the beginning for a 7/1/67, bringing the account down to zero balance, then picking up the difference between actuals and the expense claimed, and the addition to the reserve of 1 percent of the sales for that year, would bring it up to $99,000. And that is the reason for the adjustment. It is the addition to the reserve of 1 percent of sales for that year, over and above the difference between actually -- what was claimed and what was spent.

Q So, your adjustment, Mr. Faria, is that it would have been appropriate for tax payers to have reversed, $73,020 out of reserve and bring the expense account into a credit balance posture, and then any disbursements --

A Would be charged against that account, during the course of the year.

Q Right, and on that basis, if the $73,020 were reversed and the disbursements were changed, then the amount of adjustment on that basis, would be $99,138?

A Yes.

Q And --

A I cite that in my explanation of items which you

have read, where because of the four section -- section 461. It is right there. Where I used the Rio Grande-Western Railroad, as one of the cases that would illustrate the point.

Q Now, Mr. Faria, your adjustment, which is to reverse the $73,000 out of reserve and bring it into income in 1968, had the actual disbursements to the credit balance and the insurance item, which produces an overdeduction of insurance of $99,138, is the framework in which this -- framework in which the order adjustment was made, as you just explained it to us?

A That is the way I specified it here, yes.

Q Right, and the $99,138 was a disallowance of ded ons claimed?

A Or a change of accounting, either way. It can be -- you can use either method, 461 or 481. It is all pretty much the same.

Q Mr. Faria, you just used the number 481. Is it your testimony that 481 was used by you at the time of your audit adjustment?

A I considered both sections, yes, plus 446. However, in my examination as a field examiner, I just go out and get the facts. When the case is unagreed, I do not have to take a position on what section of the law; I can give two courses of action, and it is up to the

appellate division, or someone higher than a revenue agent, to make that decision. It can be done in our conference section, appellate or wherever.

To make the final determination, which section of the law is applicable. I have no authority to make the final say in the audit.

Q Do you know, Mr. Faria, that anyone in the Internal Revenue Service has made a determination that your disallowance of this $99,138, was incorrect?

A Did anyone --

Q That these people at conference or appellate or someone else, did anyone make the determination that your disallowance of this item was incorrect?

A Restate that, please.

Q Do you know --

A Yes.

Q That there is anyone, either a supervisor or at conference or appellate that made the determination that your disallowance of the item of $99,138, was incorrect?

A No, I don't know that. No.

Q Mr. Faria, I hand you again, the document which we were just looking at, which is addressed to Schuster's Express, 48 Norwich Avenue, Colchester, Connecticut, under date of March 7,1972. Can you identify that document?

A Yes, it is a revenue agent's report, mine.

MR. BRENNER: I ask that it be marked as an exhibit.

THE CLERK: Your Honor, that would be Petitioner's exhibit number 7 for identification.

**** (Whereupon, the above mentioned document was marked for identification as Petitioner's exhibit 7.)

MR. BRENNER: Would Your Honor care to examine it?

THE COURT: No, go ahead, and question.

BY MR. BRENNER: (RESUMING)

Q Would you, Mr. Faria, refer to page 10 of this revenue agent's report, the item, insurance claims. Does that item describe the disallowance or adjustment which you effected for the year 1968?

A Yes.

Q Would you read the Court, what that item says, please?

A To disallow estimated additions to a reserve for loss and damage claims, based on 1 percent of net sales each month. This disallowance follows the dictates of regs. 1.461-2 and Denver and Rio Grande-Western Railroad Company, 32 Tax Court, page 43.

Tax payer does not agree to this disallowance,

as tax payer feels, this reserve is necessary to reflect the true posture of his profit and loss.

Q Thank you. Mr. Faria, did Schuster's for the year ended June, 1968, maintain its cargo losses on a basis, wherein, estimates were made for 1 percent of sales?

A In '68?

Q Yes.

A If I say so, it must have, yes. Your books and records --

MR. WALKER: Your Honor, I will have to object to that question, for lack of relevancy, that that matter has already been covered by the stipulation of facts.

THE WITNESS: There were percentages of 5 percent for one year, two years, 4 1/2 percent, then you went to 1 percent. What part of the year you went to 1 percent, let's say in fiscal year, 6/30/68, I do not know right now. However, it was irrelevant when I write my report, all I have to show is 1 percent of sales. This will be taken up in more detail at the appellate division.

It is not my requirement at this level, to be very concerned about the case going to Tax Court, so it may not be -- that percentage may not have been for the entire year. I am not sure right now, without going back and examine the books.

BY MR. BRENNER: (RESUMING)

Q That is quite appropriate, Mr. Faria. As a matter of fact, the stipulation indicates that for the year 1968, Petitioner used an estimation of 4.5 percent for accumulating all their insurance expenses, and not 1 percent for --

A For '68?

Q That is right. Mr. Faria, reference is made in your revenue agent's report to section 1.461-2 of the regulations. Do you have any present recollection of what that provision of the regulations is?

A I would have to read it.

MR. WALKER: Your Honor, once again, I would like to object to this line of questioning. It appears that we already have stipulations as how the reserves were determined, as to what Mr. Faria, the various reasons that he had for making the adjustments, I don't see the relevance. The fact is that he made certain adjustments, and he has testified as to those adjustments he made. As to whether he made the adjustments for -- whether he stated when he made the adjustments all the possible legal terminology for back-up for the adjustments, or whether he made them for possibly a wrong reason, is irrelevant.

The fact is, he made them, that as he stated, he has made the various changes, and I don't see any benefit to be gained by continuing this line of questioning.

THE COURT: Mr. Brenner?

MR. BRENNER: Well, Your Honor, I think that if Mr. Faria's testimony is examined on the record, I think we will find that it is ambiguous as to whether he considered his adjustment as a disallowance of $99,138 or a partial disallowance and a partial bringing in of an item with respect to prior years, or a reversal of an item that was improperly deducted for prior years, on the grounds that tax payer should have restored to a credit balance an expense, an item which was improperly deducted in any year on a reserve basis.

THE COURT: Well, what is the materiality of what he did? How is that material to the issues in this case?

MR. BRENNER: It seems to me, Your Honor, that the Respondent is trying to satisfy this Court that there has been, as I read section 481, there has been in the year 1968, a change of accounting method, effected by Respondent. And it seems to me that this is the witness that Respondent has produced, to establish that fact.

MR. WALKER: Your Honor, if I can make one further comment; we have stipulated, in the stipulation of facts, submitted by us to the Court earlier, as to the way in which the Petitioner took the insurance deduction, and to the fact that they agree that the only deduction

allowable is the amounts which were actually expended in cash.

Mr. Faria was put on the stand to show that what he did, in fact, changed the accounting method. Now, as to any other reasons he may have had for making those adjustments, or as to any reasons at all, he may have had for making the adjustments, as far as the legal background is concerned, I don't see that it is material. The important thing is what adjustments he made, and if the adjustments he made as a matter of law, result in a change of accounting method, that is all we are -- that is what the issue is in this case.

I don't think it is important whether he had various other legal reasons for making those adjustments. That is just not material to the issue.

THE COURT: I agree. I think it is all immaterial. The statutory notice sets up the adjustment, and what the revenue agent did, and what went on between the time the revenue agent made the adjustment, and the statutory notice was issued, is not material to the issues in the case.

BY MR. BRENNER: (RESUMING)

Q Mr. Faria, is section 481 referred to in your revenue agent's report?

A No.

MR. WALKER: Once, again, Your Honor --

THE WITNESS: It did not have to be.

MR. WALKER: Excuse me, Mr. Faria. I object -- I would object to the question. We are still -- the question is still regarding what he gave as the reasons for making the adjustments.

THE COURT: I will sustain the objection.

BY MR. BRENNER: (RESUMING)

Q Mr. Faria, does your revenue agent's report contain a computation of Petitioner's tax liability, which would result from a determination of includibility of items under section 481?

MR. WALKER: Your Honor, once again, I will have to object for the same reason as stated earlier, that what the revenue agent's report says, as far as other than the fact that particular adjustments were made, I feel is irrelevant and immaterial to the issue.

THE COURT: Sustain the objection.

MR. BRENNER: Well, Your Honor, it's sufficient for the Respondent to introduce the revenue agent, who testified, in my mind, several different characteristics and atributes surrounding the adjustments that he made, and we cannot inquire as to whether his conduct -- we cannot inquire as to the theories which were in his mind at that time, as reflected by the revenue agent's report, it is difficult for Petitioner to determine or ascertain at what

time or by whom or under what circumstances, a section 481 adjustment was made.

THE COURT: It is immaterial when that occurred. I have already stuck Respondent with the burden of proving that the adjustment comes within the ambit of 481. Now, if he dreamed it up last night, that is immaterial to when it arose. I have stuck him with the burden of proof, which is going a long way, I can assure you.

MR. BRENNER: Well, I appreciate that, Your Honor.

THE COURT: But it doesn't matter whether the revenue agent came up with that theory, or whether someone in the appellate division came up with that theory. There are cases all over the books on that point. It is not material what went on before.

MR. BRENNER: Well, Your Honor, I would make this statement that because of the special computations and sub-terminations that 481 speaks of in the statutory requirements -- in the statute and the utter absence of these computations at any point in this proceeding, that Respondent has failed to meet the burden of proof with the introduction of this witness, and what I was trying to get at is, I thought that those facts were part of the underlying facts which are material -- may be material in your consideration. And I think you have determined that

they are not, and therefore, I think I can stop questioning Mr. Faria.

THE COURT: What underlying facts are you talking about?

MR. BRENNER: Section 481 --

THE COURT: What facts do you feel you can get from this witness? That he hasn't testified to or facts that aren't in the record?

MR. BRENNER: That section 481 was not contemplated by him.

THE COURT: That fact has no bearing on the issue before the Court. It doesn't matter whether it was before him. I have already said that Respondent had the burden of proof because they have raised it as new matter at the trial of the case.

MR. BRENNER: That he never submitted to Petitioner any material which contained the computations which would indicate that a section 481 adjustment was made.

THE COURT: Is that required?

MR. BRENNER: No, but it is some evidence. I think it is evidence.

THE COURT: Evidence of what?

MR. BRENNER: Evidence of the absence of a 481 determination.

THE COURT: He didn't make a 481 determination.

I am convinced of that. I will almost find that as a fact without your even requesting it in the brief. I have already found that this was new matter raised by the Respondent at the trial of the case.

I don't think anyone ever considered, and if they did, it is immaterial because I have already said Respondent bears the burden of proving it.

I don't think he went into 481, either.

MR. BRENNER: Mr. Faria, I have no further questions.

THE COURT: Any redirect questions?

MR. WALKER: Nothing, Your Honor.

THE COURT: Thank you, Mr. Faria. You are excused.

(Witness excused.)

MR. WALKER: I have no other witnesses, Your Honor.

THE COURT: Does Petitioner intend to call any witnesses in rebuttal?

MR. BRENNER: No, Your Honor.

THE COURT: Very well, the case is submitted. Do the parties have any requests as to brief due dates?

MR. WALKER: I would like to request 60 days, Your Honor.

THE COURT: How many days for reply? 45?

MR. BRENNER: 30 would be adequate. I think 30 would be adeuqate. 60 days for principal briefs?

THE COURT: Are those brief dates agreeable to Petitioner?

MR. BRENNER: Yes, Your Honor.

THE COURT: Very well, the parties will file simultaneous opening briefs in 60 days, followed by simultaneous reply briefs, 30 days thereafter, and the Clerk will give you those due dates.

MR. BRENNER: Your Honor, I would like to, at this time, renew my motion to -- for leave to file an amended petition.

THE CLERK: Your Honor, the original briefs are due on April 28, and the reply briefs are due on June 12.

THE COURT: Does Respondent object to the filing of the amended petition?

MR. WALKER: Just one minute, Your Honor, let me -- Respondent will have no objection to the filing of the amended petition, so long as I reserve the right, if necessary, to file an amended answer, or an answer to the amended petition, if necessary.

THE COURT: The Court will grant Petitioner's motion to file an amended petition, provided, the amended petition is signed and verified as is the original petition. And the Court will give Respondent 30 days within which

to file an answer to the amended petition.

So, the Court will permit Petitioner to withdraw the amended petition for the purposes of signing and verification. And then the Respondent will have 30 days from today to answer the petition, answer the amended petition.

MR. WALKER: Thank you, Your Honor.

THE COURT: Are there any other matters to come before the Court? Very well. The Court will recess until 9:30 tomorrow morning, at which time we will call the Chumbook case, the Morgan case, and the Faraone case.

THE CLERK: All rise. By order, this honorable Court stands in recess until 9:30.

(Whereupon, the hearing in the above recessed as described at 3:45 p.m.)

UNITED STATES TAX COURT

Certificate of Transcriber

Docket No 7420-73 Name: Sebuster's Express

The foregoing pages, numbers 1 through 78 inclusive, are the true, accurate and complete transcript prepared from the verbal recording made by electronic recording by Janet Fox on February 26, 1975 in the United States Tax Court located in Bridgeport, Connecticut, in accordance with the applicable provisions of the current reporting contract of the Court under which I have performed my duties as transcriber.

Janet Fox
(Name)

March 17, 1975
(Date)

UNITED STATES TAX COURT

SCHUSTER'S EXPRESS, INC.,

Petitioner,

vs.

Docket No. 7420-73

COMMISSIONER OF INTERNAL REVENUE,

[Filed February 26, 1975]

Respondent.

STIPULATION OF FACTS

The parties hereby stipulate and agree that for the purpose of this case the following facts and exhibits attached hereto and made a part hereof may be taken as true, subject to the rights of the parties to introduce other and further evidence not inconsistent with this stipulation and preserving the parties' rights to object, at the time of trial, to any and all portions of said stipulation and attached exhibits as they may deem to be irrelevant or immaterial:

1. The petitioner is a Connecticut corporation incorporated in 1946. Its principal place of business at the time the petition herein was filed was at 48 Norwich Avenue, Colchester, Connecticut.

2. The federal income tax returns, Forms 1120, of the petitioner were filed with the District Director, Hartford, Connecticut, for the taxable years ended June 30, 1967 and and June 30, 1968, and with the Internal Revenue Service

Center, Andover, Massachusetts, for the taxable years ended June 30, 1969 and June 30, 1970. Copies of said returns are attached hereto as Exhibits 1-A, 2-B, 3-C and 4-D, respectively.

3. The petitioner is a common carrier of freight by motor vehicle under authority granted by the Interstate Commerce Commission and various State regulatory bodies. It conducts this business in the states of Connecticut, Massachusetts, Rhode Island, New York, Delaware, New Jersey and parts of Pennsylvania.

4. In connection with its business operations, petitioner incurs expenses for costs of insurance which it carries with insurance companies with respect to various business risks including fire and other casualty insurance, workmen's compensation, liabilities for cargo loss and theft, liability for motor vehicle personal injury and property damage. Some of the forms of coverage carried by petitioner provide for retrospective audit adjustments whereby petitioner's costs of such insurance for any period cannot be accurately determined until an audit of applicable factors has been conducted by representatives of the carrier.

5. In addition to insurance coverage obtained from various insurance companies, the petitioner operates as a self-insurer with respect to certain aspects of its operation, principally payments to shippers or consignees for lost or damaged freight and losses to petitioner's motor vehicle equipment through accidents which are in the "loss deductible" portion of its collision coverage.

6. Petitioner maintains its records so that monthly operating reports would be available to its executives.

The officers of the company have directed from time to time that the monthly operating reports use a stated percentage of revenue in determining certain expenses for monthly operating statements rather than the actual expenses incurred and paid for during that month. This system has been used where monthly disbursements for a particular expense item may fluctuate widely from month to month, but management feels it can accurately predict the amount of such expense which may be determined on an average throughout the year. During years prior to the year ended June, 1965 principally all of such expense items which were maintained on an estimated basis for a monthly reporting purposes were adjusted to the actual disbursement amount at the close of the year involved.

7. In years ended June, 1966 through June, 1968 petitioner maintained its insurance expense accounts on such estimated basis and did not adjust such expense to conform to its actual disbursements for such item during each of such years. In the years ended June, 1969 and June, 1970 petitioner maintained its loss and damage claim expenses on an estimated basis and did not adjust such expenses to conform to the amount of actual disbursements for such expense in each of such years. The expense items so computed

on an estimated basis were used by petitioner in determining its insurance expense deduction and its loss and damage claim expense deduction in its tax returns for the years ended June, 1966 to June, 1970.

8. The amount by which the expense items exceeded the actual disbursements during the various periods was credited to reserve accounts on petitioner's books. Through June of 1968 the reserve account used was entitled "Reserve for Insurance" (account No. 2180-B). From July, 1968 through June, 1970 the account used was "Reserve for Loss and Damage Claims" (account No. 2680).

9. Exhibit 5-E attached hereto schedules for years ended June, 1966 to June, 1970 the amounts of charges to the relevant expense accounts, amount of cash disbursements, charges and credits to the reserve account and the end-of-period balances in such reserve accounts. No part of the balances in the reserve accounts is attributable to any period prior to July 1, 1965.

10. In year ended June, 1966 petitioner maintained its insurance expense accounts so that an amount equal to 5% of revenue would be charged as insurance expense monthly. In months in which the insurance disbursements items did not equal 5% of revenue, an adjusting entry was made increasing insurance expense and crediting an account designated "Reserve

for Insurance." In months in which the insurance disbursements items were greater than 5%, an adjusting entry reduced the insurance expense account to 5% of revenue and the reserve account was correspondingly reduced. At the close of June, 1966 the total charges to insurance expense for the year exceeded the disbursements for insurance for that year by $69,980 and that amount was the ending balance in the insurance reserve account in June, 1966.

The total insurance expense so developed on the estimated basis ($387,471) was deducted by petitioner on its return for the year ended June, 1966.

11. In year ended June, 1967 petitioner maintained its insurance expense accounts so that an amount equal to 4.5% of revenue would be charged as insurance expense monthly. In months in which the insurance disbursements items did not equal 4.5% of revenue, an adjusting entry was made increasing insurance expense and crediting an account designated "Reserve for Insurance." In months in which the insurance disbursements items were greater than 4.5%, an adjusting entry reduced the insurance expense account to 4.5% of revenue and the reserve account was correspondingly reduced. At the close of June, 1967 the total charges to insurance expense for the year exceeded the disbursements for insurance for that year by $3,040. The amount of the June, 1967 balance in the reserve account was the June, 1966 balance increased by $3,040, totaling $73,020.

The total insurance expense so developed on the estimated basis ($371,763) was deducted by petitioner on its return for the year ended June, 1967.

12. In the year ended June, 1968 petitioner maintained its insurance expense account on the basis of 4.5% of its revenue. Throughout the year this account was handled in the manner similar to the treatment described with respect to the year 1967. In connection with closing its books for the year of June, 1968, petitioner was concerned that the amount outstanding as a credit balance to its insurance reserve account did not reflect an identifiable liability or exposure for which petitioner was responsible under the terms of any agreements with its insurance carriers. At that time petitioner reviewed its freight claims register in which were lodged records concerning claims for freight lost or damaged by petitioner, including details as to the date claims were presented and the amount and proposed disposition of the claims. At June, 1968 petitioner determined that a reserve amount which would be appropriate to reflect the potential liability for settlement of its outstanding freight loss and damage claims in total was $99,138. Petitioner made an adjusting entry reducing its insurance reserve account to $99,138 by charging the reserve account $34,545, and reduced its insurance expense by a like amount.

Petitioner's insurance expense deduction on its return for the year 1968 ($413,198) was the aggregate of the items collected at a rate of 4.5% of revenue for the 12 months reduced by the adjusting entry of $34,545.

For 1968 the charges to insurance expense for the year exceeded disbursements for insurance for such year by $26,118.

13. Petitioner's insurance reserve account at June, 1968 ($99,138) represents the opening balance from June of 1967 ($73,020.) increased by the aggregate difference between the insurance expense as charged during the year and the disbursements for such year and reduced by the sum of $35,545.

14. In July of 1968 the Reserve for Insurance account (account No. 2180-B) was closed and the balance thereof was transferred to account No. 2680 entitled Reserve for Loss and Damage Claims.

15. In year ended June, 1969 petitioner maintained its insurance expense accounts on the basis of actual cash disbursements except for items related to cargo loss and damage claims. All disbursements for payment of loss and damage claims were charged against the reserve for loss and damage claims account; 1% of sales was charged as an expense for this item and that amount was credited to the reserve account on a monthly basis. In the year ended June, 1969 the items of expense of the basis of 1% of sales exceeded the cash disbursements for loss and damage claims by $20,268. By reason of these accruals, the balance in the reserve account at June, 1969 was $119,406.

The loss and damage claim expense so developed on an estimated basis ($120,598) was deducted by petitioner on its return for the year ended June, 1969.

16. In year ended June, 1970 the company procedures with respect to loss and damage claims was similar to the procedures in effect for June, 1969. During that year the claims expenses on an estimated basis exceeded the disbursements amounts by $73,534. The balance in the reserve account at the end of June, 1970 was $192,940.

The loss and damage claim expense so developed on an estimated basis ($166,375) was deducted by petitioner on its return for the year ended June, 1970.

17. Respondent's statutory notice disallows petitioner's expenses for insurance and claims and accordingly increases petitioner's taxable income for the years ended June, 1968 through June, 1970, in the following amounts:

TAXABLE YEAR ENDED	DISALLOWANCE
June 30, 1968	$99,138.00
June 30, 1969	$20,268.94
June 30, 1970	$73,533.32

Petitioner does not contest the following amounts of the disallowance by respondent which equal the difference between the amounts deducted for insurance and claim expenses on the income tax returns for the taxable years ended June 30,

1968 through June 30, 1970, and the actual expenditures for insurance and claims expenses during said taxable years:

TAXABLE YEAR ENDED	DISALLOWANCE
June 30, 1968	$20,118.00
June 30, 1969	$20,268.94
June 30, 1970	$73,533.32

18. ~~At the time of the issuance of the statutory notice~~ the statute of limitations (Section 6501(a) Internal Revenue Code) woul' have been a bar to assessment of any tax with respect to Petitioner's taxable years ended June 30, 1967 and prior years. The statutory notice relates to years ended June 30, 1967 by reason of loss carryback adjustments only. ~~Section 6501(h).~~

DATE: Feb 26-1970

NEWTON D. BRENNER
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P. O. Box 1746
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MEADE WHITAKER
Chief Counsel
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BY _____ DATE: February 26, 1970

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EXHIBIT 5-E

SCHUSTER'S EXPRESS, INC.

ANALYSIS OF CHARGES TO
INSURANCE AND LOSS AND DAMAGE CLAIMS ACCOUNTS

		Insurance Expense	Loss and Damage Expense	Cash Disbursements	Reserve Account
Year Ended June 1966					
Disbursements for Insurance	(a)	168,364		168,364	
	(b)	149,127		149,127	
Insurance Expense Charges	(a)	20,693			20,693
on Estimated Basis	(b)	49,287			49,287
Total for Year		387,471		317,491	69,980
Account Balance - Reserve for Insurance					69,980
Year Ended June 1967					
Disbursements for Insurance	(a)	199,776		199,776	
	(b)	156,456		156,456	
Insurance Expense Charges	(a)	(12,449)			(12,449)
on Estimated Basis	(b)	27,980			27,980
Disbursements Charged to Reserves				-12,491	(12,491)
Total for Year		371,763		368,723	3,040
Account Balance - Reserve for Insurance					73,020
Year Ended June 1968					
Disbursements for Insurance	(a)	132,915		132,915	
	(b)	189,896		189,896	
Insurance Expense Charges	(a)	76,222			76,222
on Estimated Basis	(b)	48,710			48,710
Disbursements Charged to Reserves				64,269	(64,269)
Adjustments to Reserve and Expense		(34,545)			(34,545)
Total for Year		413,198		387,080	26,118
Account Balance - Reserve for Insurance					99,138

a - summary for first six months of year
b - summary for last six months of year

EXHIBIT 5-E

SCHUSTER'S EXPRESS, INC.

Page 2

		Insurance Expense	Loss and Damage Expense	Cash Disbursements	Re Acc
Account Balance - Reserve for Insurance - Transferred to Reserve for Loss and Damage Claims - July 1968					
Year Ended June 1969					
Disbursements for Loss and Damage Claims	(a)			43,981	(43,
	(b)			56,349	(56,
Loss and Damage Expense Charges on Estimated Basis	(a)		58,441		58,
	(b)		62,157		62,
Total for Year			120,598	100,330	20,
Account Balance - Reserve for Loss and Damage Claims					119,
Year Ended June 1970					
Disbursements for Loss and Damage Claims	(a)			28,013	(28,
	(b)			64,828	(64,
Loss and Damage Expense Charges on Estimated Basis	(a)		85,650		85,
	(b)		80,725		80,
Total for Year			166,375	92,841	73,
Account Balance - Reserve for Loss and Damage Claims					192,

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66 T. C. No. 56

UNITED STATES TAX COURT

SCHUSTER'S EXPRESS, INC., Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7420-73. [Filed June 24, 1976.]

Petitioner, an accrual basis taxpayer, maintained some of its expense accounts on an estimated basis for monthly reporting purposes. Such estimates were also used by petitioner in computing expense deductions claimed on its Federal income tax returns for the taxable years ended June 30, 1966 through June 30, 1970. The balance of a reserve account was increased each year by the amount by which the estimates exceeded actual cash expenditures for such items during the year. Respondent determined that petitioner's accounting practice did not clearly reflect income and disallowed the deductions claimed to the extent they exceeded actual expenditures for the taxable years ended June 30, 1968 through June 30, 1970. Petitioner has conceded the correctness of these adjustments. In addition, respondent included in

petitioner's taxable income for the taxable year ended June 30, 1968, the balance of the reserve account as of June 30, 1967. Held, Sec. 481 does not permit respondent to include in petitioner's taxable income for the taxable year ended June 30, 1968, the balance of the reserve account as of June 30, 1967, because respondent's adjustments did not constitute a "change in method of accounting." Held further, assuming that a change in method of accounting did occur, the "duplication" was not "caused solely by reason of the change."

Newton D. Brenner, for the petitioner.

Robert S. Walker, for the respondent.

GOFFE, Judge: The Commissioner determined the following deficiencies in petitioner's Federal income tax:

Taxable Year Ended	Deficiency
June 30, 1967	$20,405.28
June 30, 1968	57,920.83
June 30, 1969	10,702.00

Concessions having been made by petitioner, the principal issues for decision are whether respondent's change in petitioner's accounting treatment of insurance expense constitutes a "change in method of accounting" within the meaning of section 481 of the Internal Revenue Code of 1954;[1] and, if so, whether respondent correctly

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

adjusted petitioner's taxable income for the taxable year ended June 30, 1968.

FINDINGS OF FACT

Most of the facts have been stipulated. The stipulation of facts and the exhibits attached thereto are incorporated by this reference.

Petitioner, a Connecticut corporation, is a common carrier of freight by motor vehicle and had its principal place of business in Colchester, Connecticut, at the time it filed its petition in this proceeding. Petitioner filed its Federal income tax returns with the District Director, Hartford, Connecticut, for the taxable years ended June 30, 1967 and June 30, 1968, with the Internal Revenue Service Center, Andover, Massachusetts, for the taxable years ended June 30, 1969 and June 30, 1970.

Petitioner maintained its books and filed its Federal income tax returns for the taxable years ended June 30, 1966 through June 30, 1970, under the accrual method of accounting. Petitioner maintained its records so that monthly operating reports would be available to its executives. The officers of the company required that a stated percentage of revenue be used in computing certain expenses for the monthly operating reports rather than the actual expenses incurred and paid for during that month. This

system was used where monthly disbursements for a particular expense item fluctuated widely from month to month. However, management felt that it could accurately predict the amount of such expense for the year. During years prior to the taxable year ended June 30, 1966, most of the expense accounts which were maintained on an estimated basis for monthly reporting purposes were adjusted to reflect actual disbursements at the close of the year involved.

In connection with its business operations, petitioner incurred expenses for costs of insurance. Some of the forms of coverage carried by petitioner provided for retrospective audit adjustments. Petitioner's insurance costs for any period could not be accurately determined until an audit of applicable factors had been conducted by representatives of the insurance carrier. In addition to insurance coverage obtained from various insurance companies, the petitioner operated as a self-insurer with respect to certain aspects of its operation, principally payments to shippers or consignees for lost or damaged freight and losses to petitioner's motor vehicle equipment through accidents which were in the "loss deductible" portion of its collision coverage.

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For the taxable years ended June 30, 1966 through June 30, 1968, petitioner maintained its insurance expense accounts, including those accounts relating to items for which it acted as a self-insurer, on the basis of a predetermined percentage of gross receipts. The amount by which such estimated expenses exceeded actual cash disbursements for such items was reflected on petitioner's books by the increase in the credit balance of the "Reserve for Insurance" account during such years. The amount of insurance expense so computed on an estimated basis was claimed by petitioner as a deduction on its Federal income tax returns for the taxable years ended June 30, 1966 and June 30, 1967. In connection with closing its books for the taxable year ended June 30, 1968, petitioner was concerned that the amount outstanding as a credit balance to its insurance reserve account did not reflect an identifiable liability for which it was responsible under the terms of any agreements with its insurance carriers. After reviewing its freight claims register, petitioner concluded that a reserve balance of $99,138 would be appropriate to reflect the potential liability for settlement of its outstanding freight loss and damage claims. Accordingly, the credit balance of the reserve account was

[- 5a -]

reduced to $99,138 by means of an appropriate adjusting entry. The amount of the insurance expense deduction claimed by petitioner on its Federal income tax return for the taxable year ended June 30, 1968, was equal to the amount of estimated insurance expense items reduced by the amount of the adjusting entry to the reserve account. The amount by which the insurance expense deduction claimed by petitioner on its income tax return for the taxable year ended June 30, 1968, exceeded the amount of actual cash expenditures for such items was reflected on petitioner's books by the net addition to the credit balance of the reserve account for such year. In July 1968 the "Reserve for Insurance " account was closed and the balance thereof was transferred to an account entitled "Reserve for Loss and Damage Claims." During the taxable years ended June 30, 1969 and June 30, 1970, petitioner computed its expenses for loss and damage claims for both monthly reporting and Federal income tax purposes on the basis of a certain percentage of gross receipts. The amount by which the expense deduction claimed for such items exceeded actual cash expenditures in each year was equal to the amount of the increase in the credit balance of the "Reserve for Loss and Damage Claim" account during such year.

[- 5b -]

The amounts charged to the relevant expense accounts and claimed on petitioner's income tax returns, the actual cash disbursements, and the ending balances in the reserve accounts for the taxable years ended June 30, 1966 through June 30, 1970, were as follows:

Taxable Year Ended	Insurance Expense	Loss and Damage Expense	Cash Disbursements	Ending Balance In Reserve Account
June 30, 1966	$387,471		$317,491	$ 69,980
June 30, 1967	371,763		368,723	73,020
June 30, 1968	413,198		387,080	99,138
June 30, 1969		$120,598	100,330	119,406
June 30, 1970		166,375	92,841	192,940

The Commissioner, in his statutory notice of deficiency, increased petitioner's taxable income for the taxable years ended June 30, 1968, June 30, 1969, and June 30, 1970, in the amounts of $99,138, $20,268.94, and $73,533.32, respectively, and included the following statement as his basis for adjustment:

> It is determined that the estimated additions to a reserve for loss and damage claims based on a percentage of net sales each month and claimed as a deduction is disallowed because you have not established that you are entitled to such a deduction. * * * .

OPINION

Petitioner maintained its books and filed its Federal income tax returns for the taxable years ended June 30, 1966 through June 30, 1970, under the accrual method of accounting. During each of these years petitioner maintained certain expense accounts on the basis of estimates. An expense deduction based upon such estimates was claimed by petitioner on its Federal income tax returns for the taxable

years ended June 30, 1966 through June 30, 1970. In each year the deduction claimed by petitioner on its income tax return exceeded actual cash disbursements for such items. The amount by which the deduction claimed exceeded actual cash expenditures in each year was reflected on petitioner's books by an increase in the credit balance of a reserve account. The Commissioner, in his statutory notice of deficiency, increased petitioner's taxable income for the taxable year ended June 30, 1968, in an amount equal to the balance of the insurance reserve account as of June 30, 1968. He also increased petitioner's taxable income for the years ended June 30, 1969 and June 30, 1970, in amounts equal to the respective additions to the loss and damage claim reserve account for those years. Petitioner admits the correctness of the disallowance of the deductions claimed in excess of actual expenditures for the taxable years ended June 30, 1968 through June 30, 1970, but contends that the disallowance of excessive deductions claimed in the taxable years ended June 30, 1966 and June 30, 1967, is barred by the statute of limitations in absence of the applicability of section 481.

After concluding at trial that respondent's intended reliance on section 481 constituted a new theory not within the breadth of the statutory notice of deficiency, we ruled that respondent must bear the burden of proof with respect

to the applicability of section 481 to the facts of this case. Estate of Akos Anthony Horvath, 59 T.C. 551 (1973); Arthur Sorin, 29 T.C. 959 (1958). Rule 142(a), Tax Court Rules of Practice and Procedure. However, before passing to the question of the applicability of section 481, we must first face petitioner's procedural argument that respondent is precluded from relying on section 481 to support his determination because notice of such reliance does not appear in the notice of deficiency or the pleadings filed prior to trial. Petitioner conceded at trial that he was apprised of respondent's intention to proceed under section 481 several months prior to trial and that there was no reason for the case to be continued. Commissioner v. Transport Manufacturing and Equipment Co., 478 F.2d 731 (8th Cir. 1973), relied upon by petitioner, is clearly distinguishable. In that case, the Eighth Circuit, in affirming this Court's holding that respondent could not rely on section 482 for the first time on brief, made the following observation at page 736:

> Although the most appropriate times to advise the taxpayer of the Commissioner's theories to sustain an assessment would be first in the notice of deficiency and then in the Commissioner's answer, we do not hold that the Commissioner necessarily loses his right to pursue a theory or Code section that is not specifically raised before or at trial. The basic consideration is whether the taxpayer is surprised and disadvantaged when the Commissioner has failed to plead section 482. Commissioner v. Chelsea Products, *supra* at 197 F.2d 624; Nat Harrison Associates, Inc. *supra* 42 T.C. 617; Burrell Groves, Inc. 16 T.C. 1163, 1169 (1951). However,

> the longer the Commissioner delays in not expressly advising the taxpayer of the intended theories, the more reason there is to conclude that the taxpayer has not received fair notice and has been substantially prejudiced so as to deny the Commissioner consideration of theories raised for the first time in post trial briefs. The Commissioner may avoid this uncertainty and discharge his duty of informing the taxpayer by expressly notifying the taxpayer of the intended theories in the deficiency notice and the Commissioner's answer.

Thus, the rule controlling respondent's right to rely on a particular theory is dependent upon his providing petitioner fair warning of his intention to proceed under such theory. "Fair warning in this context means that a taxpayer must not, by reason of the Commissioner's failure to timely notify him, have been prejudiced or harmed in his ability to prepare for trial." Richard Rubin, 56 T.C. 1155, 1163 (1971), affd. 460 F.2d 1216 (2d Cir. 1972). As previously indicated, petitioner readily admitted at trial that notice of respondent's intention to proceed under section 481 was given well in advance of trial. Accordingly, we hold that respondent may properly rely on section 481.

Having concluded that respondent may rely upon section 481 in support of his determination, we must now decide whether section 481 is applicable and permits respondent to include in petitioner's income for the taxable year ended June 30, 1968, the balance of the insurance reserve account as of June 30, 1967.

Section 481[2] prescribes the rules to be followed in computing taxable income in cases where taxable income is computed under a method of accounting different from that under which it was previously computed. Its purpose is to prevent any income from escaping tax or being taxed twice solely because of a change in method of accounting. While respondent is precluded by the statute of limitations from determining "deficiencies" in income tax for any of the years prior to the taxable year ended June 30, 1968, section 481, if applicable, would authorize an adjustment to income for the taxable year ended June 30, 1968, for the amount of insurance expenses erroneously deducted under petitioner's accounting practice during closed years.

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[2] SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) GENERAL RULE.--In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

Petitioner's contention is that section 481 is not applicable for the reason that there has been no "change in method of accounting," the prerequisite for the application of section 481, but rather a mere correction of an erroneous accounting practice, relying upon W. A. Holt Co., Inc. v. United States, 368 F.2d 311 (5th Cir. 1966); United States v. Catto, 223 F. Supp. 663 (W.D. Tex. 1963), affd. per curiam 344 F.2d 227 (5th Cir. 1965), reversed on other grounds, 384 U.S. 102 (1966); Walter H. Potter, 44 T.C. 159 (1965). Respondent maintains that the change in petitioner's accounting practice constitutes a "change in method of accounting" and that the balance of the insurance reserve account on June 30, 1967, must be included in income for the taxable year ended June 30, 1968, under section 481 in order to prevent a double deduction from resulting from the change in method of accounting.

Section 481 does not define the phrase "change in method of accounting." The applicable regulations provide that a "change in method of accounting" includes a "change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan." Sec. 1.446-1(e)(2)(ii), Income Tax Regs. Overall methods of accounting include the cash receipts and disbursements method, an accrual method, and combinations

of such methods. Sec. 1.446-1(a)(1), Income Tax Regs. Petitioner, an accrual basis taxpayer, was not required by respondent to change its overall method but merely to change the manner of computing its insurance expense for the taxable year ended June 30, 1968. Thus, to come within the meaning of the phrase "change in method of accounting," there must have been a change in the treatment of a "material item."

"A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction" Sec. 1.446-1(e)(2)(ii)(a), Income Tax Regs. A "change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction." Sec. 1.446-1(e)(2)(ii)(b), Income Tax Regs.

In W. A. Holt Co., Inc., v. United States, 368 F.2d 311 (5th Cir. 1966), relied upon by petitioner, the Fifth Circuit, in holding that a taxpayer's practice of charging off nonworthless debts was not a "method of accounting" within the meaning of sections 446 and 481, stated:

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> The practice of charging off accounts which were not in fact worthless when charged off is not a method of accounting.* * * This practice is nothing more than a method of distorting income in favor of the taxpayer. * * * .
>
> Taxpayer relies upon Fruehauf Trailer Company v. Commissioner of Internal Revenue, 1964, 42 T.C. 83. * * * *Fruehauf* is not persuasive. It involved the timing of the deduction, i.e., which year. Here we are concerned only with improper deductions. We hold that there was no change in method of accounting. Thus, the first condition of section 481 was not met. * * * . [368 F.2d at 312-313.]

In the instant case we are concerned with a practice involving deductions based upon estimates which, like the practice in question in W. A. Holt Co. v. United States, supra, apparently fails to relate to the proper timing of the deduction.

Peoples Bank & Trust Co., 50 T.C. 750 (1968), affd. 415 F.2d 1341 (7th Cir. 1969), cited by respondent, is clearly distinguishable. In that case the taxpayer, under the terms of agreements with depositors, computed interest semi-annually and credited it to the depositors' accounts on May 1 and November 1 of each year. Interest on funds on deposit during November and December was paid only to the extent that all or a portion thereof was on deposit on May 1 of the following year. Although no actual credits were made to accounts for funds on deposit

at the end of each year, the taxpayer claimed an interest expense deduction in the amount of the balance of a reserve account existing at the end of each year which reflected the estimated portion of the interest credits to be made on May 1 of the following year allocable to the months of November and December. The interest expense deduction claimed for each succeeding year was computed by reducing the actual credits made during the year by the amount of the estimated portion of the prior year's interest expense deduction. We held that interest expense for the months of November and December was "improperly accrued" and that respondent made a proper adjustment under the provisions of section 481. The facts of that case differ from those before us in that the taxpayer's practice relating to interest expense, although erroneous, properly reflected the taxpayer's lifetime income as a result of the restoration of the improper portion of the deduction to income in the following year; therefore, the question relating to the treatment of the item was only one of timing, i.e., which year. Respondent, the party on whom the burden of proof rests, has not established that under petitioner's method of computing insurance expense there was any procedure or intention to restore the excessive deductions to income in future years so as to properly reflect

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petitioner's total lifetime income. The deductions claimed for insurance expenses in excess of actual expenditures do not appear to properly belong in any taxable period. Thus, we do not have before us a case involving the proper time for the taking of a deduction.

Under the regulations, a change in method of accounting does not include a change in the treatment of an item which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. Sec. 1.446-1(e)(2)(ii)(b), Income Tax Regs.

In addition, there is support for the proposition that section 481 is directed only at those accounting practices which do not avoid the reporting of income, i.e., those practices which properly reflect an item's effect upon a taxpayer's lifetime income. Their usual effect is merely to postpone the reporting of income.[3] To this effect, the court in Graff Chevrolet Co. v. Campbell, 343 F.2d 568 (5th Cir. 1965), in holding that section 481 gives respondent the power to tax amounts that should have been reported in closed years, stated at page 572:

> When a taxpayer uses an accounting method which reflects an expense before it is proper to do so or which defers an item of income that should be reported currently, he has not succeeded (and does not purport to have succeeded) in permanently avoiding the reporting of any income; he has impliedly promised to report that income at a later date, when his accounting method, improper though

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[3] Hearings on H.R. 8300 before the Senate Committee on Finance, 83d Cong., 2d Sess. 2420 (1954); Note, Problems Arising from Changes in Tax-Accounting Methods, 73 Harv. L.Rev. 1564, 1568 (1960).

> it may be, would require it. Section 481, therefore, does not hold the taxpayer to any income which he has any reason to believe he has avoided, and does not frustrate the policy that men should be able, after a certain time, to be confident that past wrongs are set at rest. Note, Problems Arising from Changes in Tax-Accounting Methods 73 Harv.L. Rev. 1564, 1576 (1960).

See also Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969), affg. 50 T.C. 750 (1968). Under petitioner's method of computing its insurance expense deduction, its lifetime income would clearly have been distorted. Accordingly, based on the foregoing, we hold that respondent's change in the treatment of petitioner's insurance expense did not constitute a "change in method of accounting." Thus, the first condition of section 481 has not been met.

Even assuming that petitioner's accounting practice with respect to items of insurance expense for the taxable years ended June 30, 1966 through June 30, 1968, constitutes a "method of accounting," respondent would still not be permitted under section 481 to include in petitioner's income for the taxable year ended June 30, 1968, the balance of the insurance reserve account as of June 30, 1967. The proposed effect of section 481 is explained in the following statement of the Senate Finance Committee:

> If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deduction is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doubling ups which are due to the change in method which must be adjusted. [Emphasis added.] [S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. 307 (1954).]

Thus, a duplication or omission must be caused solely by the change in method of accounting in order for a compensating adjustment to be required under section 481. Section 481 does not provide a means by which all errors of past years during which a different method of accounting was used may be corrected. Fred P. Pursell, 38 T.C. 263 (1962), affd. per curiam 315 F.2d 629 (3d Cir. 1963). The "duplication" which respondent seeks to reach under section 481, the balance of the insurance reserve account as of June 30, 1967, was not caused "solely by reason of the change." Petitioner's total income would have been distorted by the improper deductions even in absence of the change because of the failure of such "method" to account for the excessive deductions in future years. Thus, the requisite relationship between the "duplications" and the change in method of accounting is not present. This conclusion lends support

to our holding that no change in method of accounting occurred, for it is unlikely that a change in method of accounting within the meaning of section 481 would occur without omissions or duplications resulting from the change.

Although the issue is not before us, it appears that respondent is not without a remedy. When our decision becomes final, sections 1311-1314 may be available to permit respondent to recover revenues lost in barred years. See North Carolina Granite Corp., 43 T.C. 149 (1964); Kenosha Auto Transport Corp., 28 T.C. 421 (1957).

Decision will be entered under Rule 155.

UNITED STATES TAX COURT

SCHUSTER'S EXPRESS, INC.	)	
	)	
Petitioner	)	
	)	
v.	)	Docket No. 7420-73
	)	
COMMISSIONER OF INTERNAL REVENUE	)	[Filed September 9, 1976]
	)	
Respondent	)	

DECISION

Pursuant to the opinion of the Court filed June 24, 1976, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years ended June 30, 1967, June 30, 1968 and June 30, 1969 in the amounts of $20,405.28, $21,128.50 and $10,702.00, respectively.

(signed) William A. Goffe
Judge.

Entered: SEP - 9 1976

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Date: August 31, 1976

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Date: _____

CERTIFICATE OF SERVICE

It is hereby certified that service of this appendix has been made on opposing counsel by mailing four copies thereof on this 31st day of March, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

Newton D. Brenner, Esquire
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/s/ Gilbert E. Andrews/cmk
GILBERT E. ANDREWS,
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